PROPOSED MELLON–DREYFUS MERGER

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON
ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MARCH 2 AND 3, 1994

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PROPOSED MELLON-DREYFUS MERGER

WEDNESDAY, MARCH 2, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell (chairman) presiding.

Mr. DINGELL. Today and tomorrow, this subcommittee will explore public policy issues raised by Mellon Bank's proposed acquisition of the Dreyfus Corporation, which would create the largest bank mutual fund venture in the United States. Because, in most circumstances, bank securities-related activities fall outside much of existing securities regulation, the subcommittee has serious concerns about the risk of consumer confusion, disregard of disclosure standards and suitability considerations, the creation of conflicts of interest, lack of adequate safeguards, protection of consumers, and careful and appropriate regard for the public interest.

As the SEC will testify today, bank mutual fund activity is rapidly increasing with assets in such funds increasing 29 percent since December 31, 1992, and a greater role for banks in selling mutual fund shares to the public. Many experts suggest that other large banks are watching the Mellon-Dreyfus transaction to see if and how they can climb aboard the bandwagon.

The Glass-Steagall Act, a long-standing protection from the intermingling of banking and securities activities that led to so much grief in the Great Depression, has been eroded by bank regulators and by the courts. The question before us is do we dare risk repeating the same kind of abuses that led to the enactment of Glass-Steagall in the first instance. Put another way, can the bank regulators protect the investing public to the same degree that the securities regulators do? And, indeed, do they have the will, the intent, the knowledge and the skill to do so?

Some believe that this kind of transaction significantly increases the risk to investors. As one prominent mutual fund manager views it, and I now quote, "Banks are greedy little suckers who are going to hurt the public by not informing them of the risks," involved in mutual funds. But you need not take the view that I've just quoted to see that the Federal banking law simply does not have the protections for investors afforded under the securities laws, nor do Federal bank regulators have an enviable track record of aggressive investor protection. All we have to do is look at the savings and loan scandal and the cost to the taxpayers that this

has occasioned to understand that that fact is so. Another question: are we setting ourselves up for the same level of regulatory effectiveness that led to the savings and loan fiasco?

Other banks are presently engaged in mutual fund sales and related investment advice, but none on the scale envisioned by the Mellon-Dreyfus transaction. Presumably, no one is arguing that it is acceptable to allow this or any other transaction to be approved simply because, and I now quote, "Other banks are doing it." Not closing the barn door because a few horses have escaped is silly. Investor protection should be, and must be, paramount. What we learned from a review of this transaction will likely argue for substantial changes in the statutory and regulatory treatment of existing bank mutual fund operations.

Today's hearing will outline the current regulatory scheme for bank securities activity and the risks to the investing public that arise from bank mutual fund operations. Tomorrow's hearing will focus on how the Comptroller of the Currency views this activity and how the parties to the Mellon-Dreyfus transaction have attempted, on a voluntary basis, to address the very real dangers that are apparent here.

The first witness here today will be the Honorable Arthur Levitt, Chairman of the Securities and Exchange Commission. We welcome him in his first appearance before the subcommittee, and look forward to his testimony on the shortcomings of the current regulatory structure for the securities activities of banks. He will be joined by Barry Barbash, Director of the Division of Investment Management.

The second panel of witnesses will consist of prosecutors and a civil attorney involved in the Charles Keating/Lincoln Savings and Loan matter. These men and women have seen first-hand the wreckage that can result from bank sales of securities, even when paper protections were present. We are grateful to them for their work on the matter, as well as for their sharing their views on the implications of this matter to the public and to the investors.

The third panel today is going to be comprised of consumer representatives who have done what bank regulators thus far have not—actually tested the paper protections offered by banks and actually asked consumers what they do and do not understand. These witnesses will be and should be viewed by regulators and the Congress as a cautionary reality check.

The committee wants to thank all of our witnesses today for discussing matters of great importance from the standpoint of the public interest.

The Chair now recognizes my distinguished friend from Colorado, Mr. Schaefer, for such statement as he chooses to make.

Mr. SCHAEFER. Thank you, Mr. Chairman. As you stated, today's hearing of the subcommittee begins 2 days of testimony regarding the proposed merger of Mellon Bank Corporation and Dreyfus Corporation. This merger has raised a number of issues because of its size and the range of the financial and investment services that will be available to customers at Mellon Bank branches.

This subcommittee has a long-standing interest in the Nation's financial markets, and in the functional differences between the various segments of these markets. This subcommittee has held a

number of hearings over the years on the effect of changes in the financial markets and the perceived dangers to the consumer that occur when the lines between banking and securities begin to blur a bit.

The transaction that we are beginning to examine today is not a small one. It has been valued at $1.85 billion. It is my understanding that after the merger is completed, should it be allowed to go through, Mellon Bank will be the largest bank mutual fund adviser in the country, with over 4 percent of all mutual fund assets.

The proposed merger is one of the most significant financial transactions in recent years, and while it would certainly not be the first merger of a bank and a mutual fund company, its sheer size could lead to a rush of similar mergers. The big question we need to be asking ourselves is, are there sufficient consumer safeguards under current law to safely permit a merger of this type and scope? If not, what further protections are needed to prevent customer confusion and minimize the possibility of catastrophic losses to unsophisticated investors?

As the chairman pointed out, the S&L problems, the scandal and what it has cost us to bail out through the RTC is unbelievable, and I think that none of us want to get into that situation again.

I look forward to the testimony presented in the next 2 days, and I certainly thank the chairman for holding these hearings.

Mr. DINGELL. The Chair wants to thank my good friend.

[The prepared statement of Hon. Carlos J. Moorhead follows:]

STATEMENT OF HON. CARLOS J. MOORHEAD

Thank you, Mr. Chairman. The subcommittee during the next 2 days will be examining the proposed merger of Mellon Bank Corporation and the Dreyfus Corporation. This is indeed a huge transaction—valued at $1.85 billion—which, should it occur, would propel Mellon Bank into the forefront of the mutual fund business in this country.

Whether this is a good thing or a bad thing depends to a large extent on how well informed the customers of the new entity are. Will they know when they are buying mutual funds from their bank that such funds, while offering a higher rate of return than an FDIC insured bank deposit, are also riskier? I understand that Mellon and Dreyfus have taken steps to attempt to alleviate this possible confusion, and I look forward to hearing more about those efforts.

These hearings promise to add to this committee's record of closely monitoring the changes taking place in our Nation's capital markets, and I look forward to the testimony we will hear in this regard. Thank you, Mr. Chairman.

Mr. DINGELL. The Chair now wants to welcome you, Mr. Levitt, to the subcommittee.

As you know, we have been friends a long time. I have had the opportunity to know you and to respect you, and to observe your dedication to the public interest. As you know, I welcomed your selection for the Chairmanship of the SEC, and I am delighted to have you before the subcommittee. I hope you feel welcome here.

Mr. LEVITT. Thank you very much.

Mr. DINGELL. And you, Mr. Barbash. Thank you for being with us. We appreciate your courtesy to us today.

Gentleman, it is the rule of the subcommittee that all witnesses be sworn and testify under oath. Do either of you object to testifying under oath? It is the right, gentlemen, of all witnesses who appear before the subcommittee to be advised by counsel since they

do testify under oath. Do either of you desire to be advised by counsel during your appearance?

Mr. LEVITT. No.

Mr. BARBASH. No.

Mr. DINGELL. Gentlemen, the Chair advises then that copies of the rules of the subcommittee, and of the House of Representatives are there before you in the red and the blue books for your information as you appear and testify before us.

Gentlemen, if you will then please rise and raise your right hands.

[Witnesses sworn.]

Mr. DINGELL. Gentlemen, you may each consider yourselves under oath. The Chair now recognizes you for such statement as you choose to give.

TESTIMONY OF HON. ARTHUR LEVITT, JR., CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY BARRY P. BARBASH, DIRECTOR, DIVISION OF INVESTMENT MANAGEMENT

Mr. LEVITT. Chairman Dingell and members of the subcommittee, I appreciate this opportunity to appear before you on behalf of the Securities and Exchange Commission. Accompanying me this morning is Barry Barbash, the Director of the Division of Investment Management. We are here today to discuss the concerns that Mellon Bank's acquisition of the Dreyfus Corporation raises regarding the current regulatory structure governing the securities activities of banks.

Now is the time for us to take action on the issue of functional regulation. This proposed merger, which will create the largest bank mutual fund operation in the United States with 4 percent of all mutual fund assets, I think provides us with the perfect opportunity to plan ahead. It provides the ideal backdrop to ensure that the American people will never see their financial regulators pointing their fingers at one another about who let what slip through the cracks of oversight.

The $1.85 billion of Mellon-Dreyfus is just one of the most striking examples of the recent growth of bank involvement in the mutual fund industry. Today, 113 banks and bank subsidiaries advise almost 1000 mutual funds with $204 billion in assets, which is more than 10 percent of total mutual fund assets.

Banks also are increasingly active in public sales of mutual fund shares, by some estimates, accounting for more than one-third of all new sales of money market funds. Under the current law, banks that act directly as broker-dealers or investment advisers are excluded from the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940.

These exclusion date from a time when banks were insignificant participants in the securities business mostly because of the restrictions of the Glass-Steagall Act. Applying broker-dealer and adviser regulation to banks, therefore, seemed unnecessary at that time.

Those days have passed, and this vintage structure makes less sense in the 1990's when the interpretation of the Glass-Steagall

Act has been broadened piecemeal without the benefit of a sound statutory foundation of functional regulation.

Banks already are major participants in the securities markets, and it is likely that their role will continue to grow as their customers move from insured deposits into mutual funds and other uninsured securities products. Will the bank exclusions, a historical vestige of a simpler time, continue in effect?

Because of its size, the Mellon-Dreyfus merger dramatically highlights the SEC's concerns regarding the current regulatory structure governing the securities activities of banks. If the merger is completed as originally proposed, Dreyfus is going to become a subsidiary of Mellon Bank, not the Mellon holding company. Dreyfus will remain subject to oversight under the Federal securities laws only because it has agreed to remain a separate entity, at least for the time being.

If the bank were to choose to conduct these same activities itself directly, and not through a separate corporation, the framework of the Federal securities laws would not apply. The concern that the Federal securities laws should apply to bank securities activities, and in particular to bank mutual fund sales, arises from three policy objectives.

First, protecting investors by avoiding overreaching and confusion. Second, ensuring undivided loyalty to the customer by avoiding potential conflicts of interest between banks and their affiliated mutual funds. Third, ensuring that investor protection, rather than bank safety and soundness and depositor protection, remains the foremost concern of regulation, examination, and enforcement programs.

Although the parties to the Mellon-Dreyfus transaction have taken voluntary steps to address many of these concerns, there is no guarantee that the relationship between the mutual fund activities and banking activities will not change in the future because of either economic or competitive pressures. And no statutory safeguards apply to the growing number of banks that, like Mellon, are expanding their bank mutual fund activities.

This is just the beginning. These banks should not have the option of declining to submit to securities regulation.

Of course, a major danger fostered by the current regulatory structure is that investors may not realize that the mutual fund or other security sold to them by or through their bank is not federally insured.

The SEC has long been at the forefront of publicizing this danger. Last May, the Commission staff took this issue head on by requiring prospectus cover pages of bank-marketed mutual funds, and funds with names that are similar to banks, to prominently disclose that the shares are not insured.

We sponsored an eye-opening survey which demonstrated that 66 percent of bank mutual fund shareholders believed that their funds were insured. And we are actively working with the mutual fund industry to close the regulatory gaps through investor guides and investor bulletins and whatever other devices can be employed to change this very serious misperception.

Some policymakers ask whether cooperation between the SEC and other Federal banking regulators is the answer to these con-

cerns. In fact, because of efforts that Comptroller Ludwig and I initiated, the SEC and the banking agencies have been working together on an informal basis for some time.

However, I would say that these efforts are merely a stopgap. They make the best of a difficult situation by relying largely on personal relationships and personal goodwill. Joint regulatory and inspection efforts, I think, can never really substitute for institutional relationships grounded in sound public policy and written into law after years and years of experience that will survive long after I and other current regulators have left our offices.

To replace this patchwork quilt, I would hope that Congress can ensure that the expert securities regulator designated nearly 60 years ago, the SEC, can protect investors through uniform rules consistently applied to all participants in the securities markets. Five basic points demonstrate the urgent and compelling need for functional regulation:

First, investor protection must be the priority when banks engage in securities activities. Bank safety and soundness and protection of the bank's depositors are certainly appropriate priorities when regulating banking activities that concern taxpayer insured funds. But there are other priorities when it comes to regulating bank activities in the securities marketplace.

The banks' customers in its securities activities have different interest from the banks' depositors and the FDIC and other regulators. I think one of the great SEC Chairman in history, William Cary, put it better than anything I could think of when he said in 1963: "The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. [But] these objectives neither utilize the same tools nor achieve the same results as [SEC standards of] investor protection."

Second, investors deserve a single consistent standard of protection, whether they purchase securities from a bank or a registered broker-dealer. Currently, investors who purchase securities directly from banks are not protected by the securities regulatory scheme that exists for broker-dealer, and a comparable scheme simply does not exist under banking law.

For example, bank securities sales personnel are not subject to a uniform qualification, examination, and disciplinary program that focuses on the potential for abuse that exists in connection with securities activities.

Third, customer confusion about bank sold securities simply has to be eradicated. Sales of mutual funds conducted in a bank's lobby next to the very windows which take bank deposits, or sales conducted by bank employees, may mislead customers into believing—and indeed they have misled customers into believing—that these mutual funds may be federally insured.

Common or similar names may also mislead bank customers. In spite of voluntary measures and efforts by banking regulators, recent surveys—led by an SEC-sponsored survey that was, I might add, corroborated by at least two subsequent surveys conducted by other organizations—indicate a troubling degree of investor confusion about the status of their investment in bank mutual funds.

Fourth, functional regulation would certainly be more rational than our current patchwork system. In an era of regulatory consolidation and reinventing government, a separate regulatory scheme is certainly redundant and wasteful from the taxpayer's perspective—it hardly seems appropriate for the Federal bank regulators to hire and train what becomes no more than a "mini-SEC" staff.

Finally, functional regulation would eliminate the existing regulatory gaps. Under the fragmented regulatory scheme enforced today, the Commission is unable to supervise securities activities conducted directly by banks. In an increasingly complex and interconnected financial services marketplace there is an increased danger that fraud one day might simply slip through the cracks because the SEC lacks full access to records in an examination. This, I think, is a significant and an avoidable systemic risk.

The Commission believes that these concerns have really been fully addressed by functional regulation and the bill to address that program introduced by Chairmen Dingell and Markey and Congressmen Moorhead and Fields—H.R. 3447. The Commission strongly supports this bill as a means of enhancing investor protection and eliminating the current regulatory duplication and vulcanization that inevitably result from Federal statutory exclusions for bank securities activities.

H.R. 3447 would promote consistent, functional regulation of all market participants that offer the same products and perform the same functions. It would apply proven, legally enforceable broker-dealer competency standards, supervision requirements, suitability and sales practice rules, and financial responsibility requirements to banks and bank employees involved in securities sales.

The bill would also address the conflicts of interest between banks and their affiliated investment companies. The SEC is pleased to reiterate, reinforce and restate its support for H.R. 3447, and to urge its prompt enactment.

Mr. Chairman, I welcome the opportunity to be before you today, and to address questions that you or your colleagues may have.

[Testimony resumes on p. 32.]

[The prepared statement of Mr. Levitt follows:]

TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman Dingell and Members of the Subcommittee:

I appreciate this opportunity to appear before the Subcommittee on Oversight and Investigations, on behalf of the Securities and Exchange Commission, to comment on the proposed acquisition of The Dreyfus Corporation ("Dreyfus") by Mellon Bank, N.A. and its parent bank holding company, Mellon Bank Corporation ("Mellon"). The Mellon/Dreyfus merger will result in the largest bank mutual fund operation in the United States. As such, it raises in the most dramatic context to date the Commission's concerns regarding the current regulatory structure governing the securities activities of banks. My testimony today will focus on these concerns, especially the functional regulation issues that are highlighted by the proposed transaction. I also will comment on H.R. 3447, a functional regulation bill introduced by Chairmen Dingell and Markey and Congressmen Moorhead and Fields, which the Commission strongly supports.

I. The Proposed Mellon/Dreyfus Transaction

On December 6, 1993, Mellon and Dreyfus announced their agreement to merge in a transaction valued at $1.85 billion. 1/ If the merger is completed as originally proposed, Dreyfus will become a subsidiary of Mellon Bank. Dreyfus is a registered investment adviser that advises mutual funds with $72.2 billion in assets (the sixth largest family of mutual funds in the United States). 2/ Ranked by asset size, Mellon is the 21st largest bank holding company in the United States. Mellon Bank, its lead banking subsidiary, is currently 22nd among banks in mutual fund assets under management. Mellon Bank already

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1/ See Mellon Bank & Dreyfus, "Mellon Bank Corporation and the Dreyfus Corporation to Merge in Stock Transaction Valued at $1.85 Billion," Dec. 6, 1993.

2/ See Lipper Analytical Services, Lipper Directors' Analytical Data (4th ed. 1993) ("Lipper Directors' Data"). All asset figures are as of September 30. 1993.

advises one family of funds, the Laurel funds; in addition, its parent company recently acquired the investment adviser to The Boston Company funds. Once the pending merger is completed, Mellon Bank and its affiliates, including Dreyfus, will be the largest bank mutual fund investment adviser, with $76.8 billion in mutual fund assets under management. This represents four percent of all mutual fund assets. 3/

The Mellon/Dreyfus merger is the most striking example of the recent growth of bank involvement in the mutual fund industry. Currently 113 banks or bank subsidiaries advise 943 mutual funds 4/ and bank mutual funds have $204 billion in assets, an increase of 29% since December 31, 1992. 5/ Banks also are increasingly active in selling mutual fund shares to the public. 6/

The Mellon/Dreyfus merger underscores the Commission's longstanding concerns with the existing statutory scheme, which permits bank securities activities to take place

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3/ Additional details regarding the proposed merger between Mellon and Dreyfus were set forth in a letter from Chairman Arthur Levitt to Chairmen John D. Dingell and Henry B. Gonzalez (January 7, 1994), enclosing a memorandum from the Division of Investment Management and Office of General Counsel (collectively, the "Mellon Letter.")

4/ See Lipper Analytical Services, Lipper Bank Related Fund Analysis (2d ed. 1993).

5/ See id. Commentators have noted, however, that a large part of this growth is from the conversion of bank trust assets to mutual funds, rather than from retail sales. See M. Moore, "As Trust Conversions Dry Up, What's Next," American Banker, July 7, 1993, at 14. Mutual fund assets overall now exceed $2 trillion, an increase of 26 percent since December 1992. See Investment Company Institute ("ICI") Press Release No. 94-02, Jan. 27, 1994, at 4.

6/ In the first half of 1992, banks reportedly accounted for one-third of all new sales of money market funds and 14 percent of all new sales of long-term funds. See ICI, "Mutual Fund Statistics for the Bank Distribution Channel," May 1993; "Banks Turning to Mutual Funds as Shares in Household Assets, Credit Decline," BNA Banking Daily, Dec. 21, 1993. More generally, "nearly one-quarter of America's 14,000-odd banks do some sort of brokerage business." The Economist, Nov. 6, 1993, at 105, 106.

outside the framework of the federal securities laws. These concerns include: the risk of investor confusion; the potential for conflicts of interest to arise between banks and their affiliated mutual funds; and the need for regulation, examination, and enforcement programs that focus on investor protection, rather than bank safety and soundness and depositor protection. 7/ Although the parties to the Mellon/Dreyfus transaction are adopting voluntary restraints to address many of these issues, 8/ there is no guarantee that they will adhere to these measures in the future if faced with economic and competive pressures. In addition, no legally mandated safeguards apply to the growing number of banks that, like Mellon, are expanding their bank mutual fund activities (if, for the time being, on a smaller scale). These banks should not have the option of declining to submit to securities regulation.

7/ For earlier statements of the Commission's views on these issues, see, e.g., testimony of Chairman Breeden Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning H.R. 797 (June 20, 1991); testimony of Chairman Breeden Before the Senate Committee on Banking, Housing and Urban Affairs Concerning S. 543 and S. 713 (May 7, 1991); testimony of Chairman Breeden Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance and Urban Affairs Concerning H.R. 1505, H.R. 6, and H.R. 15 (April 30, 1991); statement of Chairman Ruder Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning Financial Services Reform and Modification or Repeal of the Glass-Steagall Act (April 13, 1988); statement of Chairman Ruder Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning the Reform of the Nation's Banking and Financial System (Dec. 9, 1987); statement of Chairman Ruder Before the Senate Committee on Banking, Housing and Urban Affairs Concerning Repeal of the Glass-Steagall Act, S. 1886, and S. 1891 (Dec. 3, 1987); testimony of Chairman Ruder Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning Structure and Regulation of the Financial Services Industry (Oct. 5, 1987); Memorandum of the SEC to the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning Financial Services Deregulation and Repeal of the Glass-Steagall Act (April 11, 1988).

8/ See Mellon Letter; letter from Frank V. Cahouet, Chairman, President, and CEO, Mellon Bank Corporation, and Howard Stein, Chairman and CEO, The Dreyfus Corporation, to Chairman John D. Dingell (Feb. 18, 1994).

Under the existing statutory framework, banks are excluded from the federal regulatory scheme for broker-dealers and investment advisers. 9/ These bank exclusions date from a time when banks were insignificant participants in the securities business, and applying broker-dealer and adviser regulation to banks was therefore unnecessary. That time has passed. Banks already are major participants in the securities markets, and it is likely that bank involvement in securities activities will continue to grow as their customers move, with encouragement from the banks, from insured deposits into mutual funds and other securities products that are uninsured. 10/ Yet the bank exclusions, a historical vestige of a simpler time, continue in effect.

The proposed Mellon/Dreyfus merger, by virtue of its scope alone, demonstrates that the need for consistent and comprehensive regulation of bank securities activities is more pressing than ever. Securities activities need to be subject to functional regulation: uniform rules that are consistently applied by one expert regulator to all market participants, regardless of whether they are banks or securities firms. The following points illustrate why functional regulation is necessary in the current market environment:

9/ This testimony focuses throughout on banks' direct securities activities. Bank affiliates and subsidiaries that engage in securities activities, unlike banks that engage in such activities directly, are not excluded from regulation under the federal securities laws; affiliates and subsidiaries must register with the Commission and comply with the same requirements applicable to other broker-dealers and investment advisers.

10/ The American Bankers Association has predicted that "[s]ometime in the next few months, and probably sooner rather than later, mutual fund assets will exceed total commercial bank deposits. Already mutual funds hold a bit more than $2 trillion, while bank deposits stand at about $2.4 trillion." Bankers News, vol. 2, issue 4, Feb. 15, 1994, at 7. Similarly, the San Francisco Federal Reserve Bank has identified an ongoing "secular shift" from bank intermediation of funds toward mutual fund intermediation. See "Banks Turning to Mutual Funds as Shares in Household Assets, Credit Decline," BNA Banking Daily, Dec. 21, 1993.

- **The existing regulatory system needs to be rationalized.** The existing regulatory scheme for bank securities activities simply makes no sense. While bank affiliates and subsidiaries that engage in securities activities must register with the Commission like any other broker or dealer, banks that engage directly in securities activities continue to be exempt from broker-dealer regulation. In short, the law elevates corporate form over substance. The unique treatment afforded bank securities and mutual fund activities also stands in contrast to the regulatory schemes for bank municipal and government securities activities, which are regulated under the federal securities laws. Finally, the continued existence of a separate regulatory scheme for banks makes little sense in an era of regulatory consolidation. At a time when government resources are strained, it hardly seems appropriate for the federal bank regulators to hire and train a "mini-SEC" staff, to perform potentially duplicative and overlapping examinations, when a government agency already exists to do the job.

- **Regulatory gaps need to be eliminated.** Under the existing fragmented regulatory scheme, the Commission is unable to supervise bank securities activities, which are an increasingly important segment of the securities industry. As the regulator charged with oversight of the securities markets, the Commission needs to have a comprehensive view of those markets and the participants in them. Our nation's capital markets are the largest, best, and most liquid in the world, but their continued success depends in considerable part on fair and effective regulation, and public confidence in that system of regulation.

- **Investors deserve a single, consistent standard of protection, whether they purchase securities from a bank or a registered broker-dealer.** Currently, investors who purchase securities directly from banks are not protected by the securities regulatory scheme that exists for broker-dealers. While banks that sell securities and advise investment companies are excluded from federal securities regulation, federal banking law does not provide a comparable regulatory scheme for bank securities activities. For example, bank securities sales personnel are not tested for competence, nor are they subject to an examination and disciplinary program, such as the program administered by the National Association of Securities Dealers, Inc. ("NASD"), that focuses on the potential for abuse that exists in connection with securities activities.

- **Investor protection must be a priority.** Bank regulation and examination generally seek to ensure bank safety and soundness and depositor protection. Thus, bank regulators typically focus on maintaining the institution, rather than on investor protection. Notably, the guidelines issued recently by the federal banking regulators are not enforceable by the banking regulators or by bank customers. Moreover, federal banking laws do not generally contain private rights of action for investors and there is no banking laws counterpart to the securities arbitration scheme for bank securities investors. In contrast, investor protection is paramount under the federal securities laws, and the Commission's enforcement program is driven by investor protection principles.

- **Customer confusion about bank-sold securities needs to be eradicated.** Sales of mutual funds conducted in a bank's lobby or through bank employees may mislead customers into believing that the mutual funds are federally insured. Common or similar

names may also mislead bank customers. 11/ Despite voluntary measures and efforts on the part of banking regulators, recent surveys indicate a troubling degree of investor confusion about the uninsured status of bank mutual funds. 12/

The Commission believes these concerns are fully addressed by H.R. 3447, which the Commission strongly supports. Clearly, today's market realities indicate that the time has come for Congress to eliminate the existing statutory exclusions for banks.

The remainder of this statement provides more comprehensive historical and background information on the existing regulatory structure for bank securities activities. It also comments in greater detail on H.R. 3447.

11/ The Commission's staff expressed its concern about the risk of customer confusion last May when it required any mutual fund whose shares are sold by or through a bank to disclose prominently, on the cover page of its prospectus, that shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank, and that the shares are not federally insured by the Federal Deposit Insurance Corporation or any other agency. See Letter from Barbara J. Green, Deputy Director, Division of Investment Management to Registrants (May 13, 1993).

12/ See, e.g., Testimony of Chairman Arthur Levitt Before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs (Nov. 10, 1993); Joint News Release of the American Association of Retired Persons, Consumer Federation of America, and North American Securities Administrators Association (Jan. 13, 1994). The Commission is currently in the process of planning further surveys, in coordination with the federal banking regulators, to ascertain the extent of investor confusion. Concerns on this score are heightened, moreover, by recent press reports which suggest that bank salespeople may be disregarding disclosure standards and suitability considerations when they recommend investments. See "Should You Buy Mutual Funds from Your Bank?", Consumer Reports, March 1994, at 148; S. Lipin, "U.S. Warns Banks on Failure to Comply with Guidelines in Selling Mutual Funds," Wall St. Journal, Nov. 8, 1993, at A16; K. Holliday, M. Moore, & K. Talley, "Spot Check Finds Failures to Warn About Fund Risks," American Banker, Nov. 29, 1993, at 1.

II. Existing Regulatory Structure for Bank Securities Activities

A. Historical Background

When the Securities Exchange Act of 1934 ("Exchange Act") was enacted, banks were excluded from the regulatory scheme provided for brokers and dealers, based in large part on the assumption that the Glass-Steagall Act barred banks from engaging in most securities activities.13/ Although that presumption may have been warranted at the time, it is no longer valid. Over the last two decades, the federal banking regulators have expansively interpreted the Glass-Steagall Act in a manner that permits banks to engage in a wide range of brokerage and other securities activities that are comparable to, and competitive with, services offered by registered broker-dealers. Because the statutory exclusions remain in place, however, banks that engage in securities activities, including sales of mutual funds and other securities to the investing public, have the option of conducting those activities outside the framework of the federal securities laws.

Based on the same reading of the Glass-Steagall Act, banks were (and remain) excluded from federal regulation as investment advisers under the Investment Advisers Act of 1940. Thus, even though banks now provide investment advice to a wide range of individuals and registered investment companies, they do so outside the regulatory structure established under the federal securities laws. The Commission is not expressly authorized to conduct inspections of banks that serve as investment advisers -- a limitation which in turn

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13/ See Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 86 (Feb. 16, 1934)(statement of Thomas G. Corcoran, an administration spokesman and a principal drafter of the Exchange Act).

hinders the Commission's ability to oversee the operations of the banks' affiliated investment companies.

Federal banking law, moreover, does not fill the significant gaps created by the bank exclusions contained in the federal securities laws. As illustrated below, developments over the past two decades have only caused the gaps to grow wider.

The Commission first analyzed the regulatory scheme for bank securities activities in 1977, when it issued a Report on Bank Securities Activities ("Bank Study"), as mandated by Section 11A(e) of the Exchange Act. 14/ Because bank securities activities were far less extensive at that time than they are today, the Commission did not recommend full broker-dealer registration for banks engaging in securities activities. Instead, the Commission recommended the enactment of legislation that would require the federal banking agencies to adopt and enforce, in consultation with the Commission, specific rules governing the conduct of banks engaged in securities activities, with a mandate to provide investor protection. In addition, the Commission urged that bank employees and bank examiners receive specific training in the securities laws and practices of the securities markets. Finally, the Commission recommended that the federal banking agencies be required to consult regularly with the Commission regarding their securities examination programs, share information regarding examination results, and inform the Commission of actual or potential violations of the federal securities laws.

In response to the Bank Study, the federal banking regulators indicated that they could adopt the necessary regulations without a Congressional mandate. The federal banking

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14/ See Report on Bank Securities Activities of the Securities and Exchange Commission Pursuant to Section 11A(e) of the Securities and Exchange Act of 1934 (Public Law 94-29), August 1977.

regulators, however, eventually adopted only limited recordkeeping and confirmation requirements for securities transactions. The other recommendations of the Bank Study were not implemented.

In the early 1980s, banks began to offer publicly-advertised discount brokerage services. Because the bank regulatory scheme made no provision for investor protection, the Commission responded to this development in 1985 by adopting Rule 3b-9, which would have required banks engaged in public brokerage business to register with the Commission. 15/ However, Rule 3b-9 was struck down by the courts. 16/ The Commission subsequently recommended that Congress enact the Bank Broker-Dealer Act, legislation that would have brought most bank broker-dealer activities within the regulatory framework established under the federal securities laws. 17/

B. Overview of Current Regulatory Structure

Before turning to recent developments relating to bank securities activities, it is important to consider the existing regulatory structure for bank securities activities and some of the more significant regulatory disparities that exist with respect to bank broker-dealer and investment adviser activities.

15/ At the time Rule 3b-9 was proposed, Commission staff negotiated extensively with OCC staff in an attempt to agree on a joint position regarding when bank securities activities should be moved into separate subsidiaries. However, the OCC staff ultimately determined not to proceed with a counterpart rulemaking project. See 49 Fed. Reg. 15089 (Apr. 17, 1984), withdrawn in 50 Fed. Reg. 31605 (Aug. 5, 1985).

16/ ABA v. SEC, 804 F.2d 739 (1986), reh'g denied, No. 86-80 (D.C.Cir. Jan. 12, 1987).

17/ The Bank Broker-Dealer Act was introduced in the Senate by Senator D'Amato on May 8, 1987, and in the House by Congressman Markey on May 28, 1987, but was never passed.

General. Banking regulation has traditionally focused on the safety and soundness of the banking system and the protection of depositors as opposed to investor protection and the maintenance of fair and orderly markets. Federal banking law has no statutory counterpart to the federal securities regulatory scheme. Moreover, at present, federal banking regulation does not provide a comprehensive regulatory scheme for bank securities activities.

Bank Broker-Dealer Activities. With the exception of limited recordkeeping and confirmation requirements relating to bank securities transactions, federal banking regulations do not specifically address direct bank securities activities. 18/ Notably, banks do not have to register or meet securities-related financial responsibility requirements in order to engage in direct securities activities. 19/ Moreover, federal deposit insurance coverage does not extend to customers' securities accounts (unlike coverage provided by the Securities Investor Protection Corporation ("SIPC")).

Most critical to investors, however, is the fact that banking regulations contain no provisions comparable to the federal securities law rules respecting securities training,

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18/ See, for example, 12 C.F.R. §§ 12.1-12.7, 12 CFR §§ 344.1-344.7, and 12 CFR § 208.8(k). The discussion that follows excludes the Federal Reserve Board's so-called "Section 20" orders and the FDIC's regulation governing "bona fide securities subsidiaries," 12 C.F.R. § 337.4. Those orders and rules apply to bank affiliates and subsidiaries -- not to direct bank securities activities, the subject of this testimony.

19/ National banks that engage directly in securities activities do so under their authority to engage in activities that are "incidental to banking." Federal banking regulators do not have formal advance notice of such "incidental" securities activities, making it difficult for such agencies to get a complete view of a bank's overall activities. See, e.g., D. Cope, "Agencies Face Tough Job in Gathering Fund Data," American Banker, Jan. 31, 1994, at 18; see also "GAO to Send Banks Questionnaire on Mutual Fund Activity," Wall Street Letter, Feb. 14, 1994, at 7.

qualification, suitability, and other sales practice issues. 20/ For example, federal banking law contains no counterpart to the testing and qualifications programs (e.g., the Series 7 examination) administered by the securities self-regulatory organizations ("SROs"). Moreover, bank securities customers have no formal avenue of redress for complaints. The federal banking laws do not generally contain private rights of action for investors, 21/ and there is no banking law counterpart to the securities arbitration scheme for bank securities investors.

Finally, banking agency enforcement programs historically have not emphasized investor protection. In fact, it appears that the federal banking regulators generally seek to minimize disclosure of their enforcement actions against banks. 22/ This is in contrast to the Commission's enforcement program, which fully and aggressively informs the investing

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20/ These issues were discussed previously in a Memorandum of the Securities and Exchange Commission to the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning Financial Services Deregulation and Repeal of the Glass-Steagall Act (April 11, 1988).

21/ See, e.g., In re Fidelity Bank Trust Fee Litigation, 839 F. Supp. 318 (E.D. Pa. 1993); In re Corestates Trust Fee Litigation, 837 F. Supp. 104 (E.D. Pa. 1993). Of course, banks are subject to section 10(b) of the Exchange Act and Rule 10b-5 thereunder, so bank customers can presumably bring private rights of action against banks under these provisions. But see Simpson v. Mellon Bank, N.A., [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,027 (E.D. Pa. 1993) (National Bank Act preempts application of federal securities laws in case challenging reasonableness of sweep fees charged by national bank: "The comprehensiveness of the National Bank Act in addressing the fees charged by banks as fiduciaries excludes application of the federal securities law [even though customers had no private right of action under the National Bank Act with respect to such fees].")

22/ While the banking agencies are required to "publish and make available to the public" final orders issued in connection with enforcement proceedings, the banking agencies' releases usually do not describe the nature of the violation and the enforcement action taken. 12 U.S.C. § 1818(u). Rather, the releases are lists of enforcement actions that typically only include the docket number, names of the parties involved, the type of action, the date of the action, and whether the action was by consent. It is difficult for an investor to determine from the listings which proceedings are of interest in order to request copies of documents of specific final actions from the banking agencies.

public of enforcement actions under the federal securities laws. Commission and SRO disciplinary proceedings are matters of public record. Commission press releases describe the nature of the proceedings and the identity of the parties disciplined. In addition, (as mandated by the Exchange Act), the NASD operates an "800" number hotline which allows investors to obtain information about the disciplinary and civil liability records of broker-dealers' registered representatives.

Bank Investment Adviser Activities. Although bank fiduciary activities are subject to inspection by the federal banking regulators, there is currently a regulatory gap when banks act as advisers to registered investment companies. Bank inspections do not focus on issues such as conflicts of interest under the Investment Company Act, nor are they coordinated with Commission inspection and enforcement efforts, which focus on such securities law issues. While Commission examiners inspect bank-advised investment companies, they cannot also examine the bank adviser's books and records because bank advisers are not required to register with the Commission as investment advisers. This limitation impairs the Commission's ability to examine investment companies and enforce their compliance with the federal securities laws.

The lack of express authority to review a bank's investment adviser activities particularly hinders the Commission's ability to evaluate potential conflicts of interest when the bank acts as an adviser to an investment company. For example, in order to determine whether an adviser is allocating securities transactions in a manner that is fair to all of its advisory clients, including an investment company, the Commission's examination staff must have access to records reflecting securities transactions for all of the advisers' clients. When the adviser to an investment company is a bank, however, the Commission staff does

not have express authority to review the adviser's records relating to clients other than the investment company. 23/

A bank that advises mutual funds faces other potential conflicts of interest that are not regulated by banking law. To address such conflicts of interest, the Commission has supported legislation that would amend the Investment Company Act of 1940 to: (i) prohibit an investment company from borrowing from an affiliated bank; (ii) prohibit an investment company from purchasing securities in an underwriting when the proceeds of that underwriting will be used to retire debt owed by the issuer to an affiliated bank; (iii) prohibit an investment company's investment adviser that also acts as trustee for trust clients from voting on behalf of those clients to continue its service as the investment adviser when that continued relationship is not in the shareholders' best interest; and (iv) prohibit an investment company from using an affiliated bank as a custodian. These are the types of abuses that existed historically and contributed to the adoption of the Glass-Steagall Act prohibitions. Although many of the Glass-Steagall prohibitions have been eroded, provisions have not been enacted to address these potential conflicts.

C. Recent Developments Relating to Bank Securities Activities

Against the backdrop of this limited regulatory environment and liberal interpretations of the Glass-Steagall Act by the federal banking agencies, there has been an ongoing

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23/ Notably, a recent Commission enforcement cases involved a mutual adviser's unfairly allocating securities transactions. The adviser's employees delayed designating the account for which trades were conducted until after the trades were executed and then allocated more favorable trades to a private profit-sharing plan for the adviser's employees and less favorable trades to the adviser's public mutual funds. The Commission required the adviser to pay $9.2 million in compensation to the funds' shareholders. See In the matter of Kemper Financial Services, Inc., Investment Advisers Act Release No. 1387 (Oct. 20, 1993).

expansion of bank securities and mutual fund activities. In particular, in recent years bank involvement in direct sales of mutual funds and other securities has grown significantly. In addition, banks have become increasingly involved in advising registered investment companies.

These developments have sparked new interest in the issue of the appropriate regulation of bank securities activities. Of particular concern have been various investor protection issues, particularly the problem of investor confusion as to common name funds and deposit insurance protection. In response, in 1993 the four federal banking regulators separately issued "guidelines" designed to address some of the investor protection issues raised by bank securities and mutual fund sales. 24/ These guidelines represented recognition by the federal banking agencies of the shortcomings in their regulatory structure for bank securities activities. The banking agencies subsequently issued a joint interagency statement intended to consolidate, standardize, and supersede the earlier, separate guidelines.25/

The guidelines contained in the recent Interagency Statement do not succeed, however, in creating a regulatory scheme comparable to regulation under the federal securities laws. As "guidelines," rather than regulations, they are generally hortatory in nature and are not legally enforceable by the bank regulators or by bank customers. Moreover, the guidelines do not establish clear and uniform standards of conduct for banks

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24/ See OCC Banking Circular No. 274 (July 19, 1993); letter from Richard Spillenkothen, Director, Federal Reserve Division of Banking Supervision and Regulation, on "Separation of Mutual Fund Sales Activities from Insured Deposit-Taking Activities" (June 17, 1993); FDIC Supervisory Statement on State Nonmember Bank Sales of Mutual Funds and Annuities (Oct. 8, 1993); OTS Bulletin 23-1, "Guidance on the Sale of Uninsured Products" (Sept. 7, 1993).

25/ See "Interagency Statement on Retail Sales of Nondeposit Investment Products," Feb. 15, 1994, at 2, n.1.

engaged directly in securities activities. The standards are general in nature, and banks are given wide latitude to establish procedures and policies to implement them. For example, the new Interagency Statement advises banks to "ensure that [their] personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended." 26/ The Statement does not, however, establish anything approaching the NASD's uniform and comprehensive scheme for testing and qualification of broker-dealer personnel. Similarly, the discussion of suitability and sales practices contained in the Interagency Statement does not even make reference to the NASD's long-established Rules of Fair Practice. Finally, the recent guidelines raise serious potential problems of regulatory overlap and conflict in their provisions for banking regulator oversight of registered broker-dealers that assist banks in the sale of securities products.

Although these recent efforts are laudable, they do not address the fundamental disparities between the bank securities regulatory scheme and the protections afforded investors under the federal securities laws.

III. H.R. 3447

H.R. 3447, the "Securities Regulatory Equality Act," would provide for functional regulation of bank securities activities, thus eliminating the anachronistic disparities in the existing regulatory structure. The Commission strongly supports H.R. 3447. As stated in a memorandum accompanying a recent letter from Chairman Levitt to Chairman Dingell:

26/ Interagency Statement at 11.

> H.R. 3447 would serve investors by applying proven, legally enforceable broker-dealer competency standards, supervision requirements, suitability and sales practice rules, and financial responsibility requirements to banks and bank employees involved in securities sales. The legislation would address the conflicts of interest between banks and their affiliated investment companies . . . . In general, by eliminating the unconditional bank exclusions in the federal securities laws, H.R. 3447 would promote consistent, functional regulation of all market participants that offer the same products and perform the same functions. 27/

The bill would eliminate the outmoded broker-dealer exemptions for banks, and would require most bank securities activities to be moved into separate corporate entities subject to the federal regulatory scheme for brokers and dealers generally. H.R. 3447 would also eliminate from the federal securities laws certain exemptions for banks' pooled investment and investment advisory activities. In addition, the bill would subject bank and thrift securities (but not deposit instruments) to the registration requirements of the Securities Act of 1933 (the "Securities Act") and would consolidate within the Commission jurisdiction over periodic reporting by banks and thrifts under the Exchange Act. What follows is a more detailed discussion of some of H.R. 3447's provisions.

A. Broker-Dealer Regulation

The broker-dealer provisions of H.R. 3447 are built on a sound and simple principle: banks that sell securities should be subject to the same rules as all other securities firms -- no more and no less stringent. H.R. 3447 would largely eliminate the exemptions in the federal securities laws for banks that engage in broker-dealer activities. Part A of Title I of the bill would require most bank securities activities to be moved into separate corporate entities that would be subject to the federal regulatory scheme for brokers and dealers. Thus, banks that engage in securities activities would be subject to Commission and SRO

27/ Mellon Letter, memorandum at 11.

rules specifically designed for the protection of investors, particularly those relating to sales practices and market integrity. Elimination of the exemptions for banks would also permit the application of appropriate safeguards between a bank's deposit-taking and broker-dealer activities, a step that would largely eliminate customer confusion regarding the extent to which bank-sold securities are covered by federal deposit insurance. Finally, Commission oversight of all participants in the securities markets would facilitate equal regulation of securities activities irrespective of industry classifications and market regulation generally.

The bill's general requirement that banks conduct their brokerage activities in a separate firm registered with the Commission would be subject to two limited, but important, exceptions. Under H.R. 3447, a bank would continue to be excluded from the definition of broker in Section 3(a)(4) of the Exchange Act if it engaged in fiduciary activities permissible for national banks, without publicly soliciting brokerage business or receiving compensation for such business in the form of commissions or similar payments. This exception would not require registration of securities activities effected by banks in the performance of traditional fiduciary functions, where securities brokerage is not publicly advertised and where transaction-related compensation is not received. Another limited exception from the definition of broker would permit banks to effect transactions in exempted securities (other than municipal securities), or in commercial paper, bankers' acceptances, or commercial bills without registration.

Similarly, H.R. 3447 would amend the definition of dealer in Section 3(a)(5) of the Exchange Act to include banks, except in two cases. A bank would continue to be excluded from the definition of dealer only so long as the bank purchased and sold (1) commercial paper, bankers' acceptances, commercial bills, or exempted securities (other than municipal

securities), or (2) securities for investment purposes for the bank or for accounts in which the bank, acting as trustee, is authorized to determine the securities to be purchased or sold.

Finally, H.R. 3447 would give the Commission general authority to exempt conditionally or unconditionally any person or class of persons from the definitions of broker or dealer (or from the requirement that bank securities activities be placed in a separate corporate entity) if the Commission finds such an exemption would be consistent with the public interest, the protection of investors, and the purposes of the Act. We anticipate that this exemptive authority would be sufficient to prevent any unnecessary burden on banks, and would expect to so apply it.

B. Investment Companies and Investment Advisers

H.R. 3447 would remove the artificial distinction under the Investment Advisers Act of 1940 between banks that advise registered investment companies and other fund advisers by removing the Advisers Act exclusions for banks and bank holding companies that advise registered investment companies. A bank or a holding company that serves as an adviser to a mutual fund, therefore, would be regulated as any other investment adviser to a registered investment company. H.R. 3447 also would prohibit funds advised by banks or bank holding companies from using a name which is the same as or similar to the name of the affiliated bank.

H.R. 3447 also recognizes that banks that advise investment companies face certain potential conflicts of interest that are not expressly addressed by current law. Accordingly, H.R. 3447 would prohibit specific types of transactions between investment companies and

their bank affiliates, but would grant the Commission authority by rule, regulation, or order to permit those transactions, subject to conditions it may impose to protect investors.

First, H.R. 3447 would generally prohibit an investment company from knowingly acquiring a security, during the existence of an underwriting or selling syndicate, if the proceeds from the acquisition would be used to retire any part of an indebtedness owed to a bank that is an affiliated person of the investment company. In the absence of appropriate restrictions, a bank could be tempted to use its affiliated investment company as a source of readily available capital to bail out a financially troubled borrower. The bank's indebtedness would be repaid, but the investment company would be left with risky or potentially overvalued assets.28/ H.R. 3447 would expressly prohibit this abuse of the relationship between an investment company and an affiliated bank. At the same time, H.R. 3447's grant of exemptive authority to the Commission would allow the Commission to ensure that investment company shareholders are not disadvantaged by this limitation on permissible mutual fund investments.

Second, H.R. 3447 would expressly prohibit any registered open-end investment company from borrowing money from any bank that is an affiliated person of the company. This prohibition is designed to address the potential abuse of overreaching by a bank in a loan transaction with an affiliated investment company. Again, H.R. 3447 would provide that the Commission could grant exemptions from this prohibition.

28/ In the circumstances described, the bank's corporate borrower and the investment company would generally not be "affiliated persons" for purposes of the Investment Company Act, and thus would not be subject to the Act's express prohibitions against transactions between an investment company and its affiliated persons.

Third, H.R. 3447 would restrict the use of banks and affiliated persons of banks as custodians for affiliated management investment companies 29/ and unit investment trusts ("UITs"). Currently, the Investment Company Act establishes certain criteria for a bank that serves as the trustee of a UIT. The Act also requires every management investment company to maintain its securities and similar investments in the custody of a bank, or, subject to Commission rules, in a member of a national securities exchange or the investment company itself. While the rule governing investment company self-custody of assets has been applied in situations where an investment company uses an affiliated bank as custodian, the Commission believes that it would be appropriate for the Investment Company Act expressly to prohibit affiliated bank custodianships except under conditions to be established by the Commission. H.R. 3447 would accomplish this goal.

H.R. 3447 also addresses the conflicts that may arise when a bank that advises a registered investment company also holds, as trustee for the bank's trust clients, a controlling interest in the investment company. In such a case, the effectiveness of the protections available to investors under the shareholder voting provisions of the Investment Company Act would be called into serious question. Accordingly, H.R. 3447 would prohibit a bank from both serving as adviser to an investment company and owning a controlling interest in that investment company in its capacity as trustee to the shareholders of the company, except as permitted by Commission rule or order. This prohibition would eliminate the potential for overreaching inherent in a bank's performance of these conflicting functions.

29/ A "management investment company" includes all open-end and closed-end investment companies.

H.R. 3447 contains other important provisions that address the relationship between mutual funds and affiliated banks. For example, the bill would expand the definition of "interested person" of an investment company to include: (1) any person who, within the past six months, executed portfolio transactions for, engaged in any principal transactions with, or loaned money to the investment company, and (2) any employee of a bank that acts as custodian to a transfer agent. H.R. 3447 would also allow the Commission to include within the definition of "affiliated person" of an investment company certain persons who had within the past two years a material business or professional relationship with the investment company. In addition, H.R. 3447 would amend the statutory limit on the number of officers, directors and employees of any one bank who may be members of an investment company's board of directors.

C. Common Trust Funds

H.R. 3447 would clarify that bank common trust funds must register as investment companies if they are offered to the general public. This provision would codify the Commission's existing and long-held interpretation of the common trust fund exclusion under current law. In accordance with clear legislative intent, 30/ the Commission has interpreted the exclusion to apply only when a common trust fund is used solely as an accommodation for bona fide pre-existing trust clients of a bank: that is, the exemptions

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30/ H.R. Rep. No. 1382, 91st Cong., 2d Sess. 43 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 27 (1969) ("[the Securities Act exemption] is limited to interests in or participation in common trust funds maintained by a bank for the collective investment of assets held by it in a bona fide fiduciary capacity and incident to a bank's traditional trust department activities; it would not exempt interest or participation in bank funds maintained as vehicles for direct investment by individual members of the public").

rest on the assumption that a common trust fund is used only for a "bona fide fiduciary purpose" and not a vehicle for general investment by the public. 31/

D. Securities Issuance and Disclosure

In a related area, the Commission also has long supported functional regulation of financial and periodic reporting by banks. 32/ Specifically, the Commission has for many years urged the repeal of Section 12(i) of the Exchange Act. Under Section 12(i), roughly 500 banks and thrifts file their routine issuer-related securities filings with one of the four federal banking regulators rather than the Commission. This treatment of banks and thrifts is unique: all other public companies (more than 11,000 of them, including approximately 1250 bank and thrift holding companies), file their securities reports with the Commission. The banking regulators joined with the Commission in endorsing repeal of Section 12(i) in connection with the 1984 Bush Task Group Report and the 1991 Treasury Report on Modernizing the Financial System.

H.R. 3447 would amend Sections 3(a)(2) and 3(a)(5) of the Securities Act and would repeal Section 12(i) of the Exchange Act. Sections 201 and 202 of the bill would repeal the exemptions from registration in the Securities Act for bank and thrift securities, and Section 211 would eliminate current gaps in the uniform administration and enforcement of the

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31/ H.R. Rep. No. 429, 88th Cong., 1st Sess. 11 (1963); see also Investment Company Act Release No. 3648 (Mar. 11, 1963). Recent legislative proposals to permit tax-free conversions of common trust funds into registered investment companies may encourage banks to transfer these trust assets into mutual funds. See Tax Simplification Act of 1993 (H.R. 13), 103rd Cong., 1st Sess. § 623 (1993).

32/ See, e.g., testimony of James R. Doty Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning Proposed Amendments to the Securities Exchange Act of 1934 (August 2, 1990); Memorandum of the SEC for the Task Group on the Regulation of Financial Services ["Bush Task Group"] (April 19, 1983).

disclosure requirements for banks and thrifts under the Exchange Act. Under Sections 204 and 205, bank and thrift deposits would continue to be exempt from Securities Act registration. These provisions would add a new Section 3(d) to the Securities Act, providing that certificates of deposit, savings accounts, and certain other bank and thrift instruments that might otherwise be deemed to be securities are generally exempt from the registration (but not the antifraud) provisions of that Act.

The Commission continues to strongly support the repeal of these outdated exemptions from the federal securities laws. Each of these exemptions weakens the overall system of protection of investors, and they are not necessary to serve the interests of a strong banking system.

Inevitably, with five regulators, there are inconsistencies in the interpretation and application of disclosure policies. These disparities make it difficult for investors to locate33/ and to obtain accurate and fully comparable information about all financial institutions. By consolidating securities disclosure regulation in the Commission, H.R. 3447 would eliminate inconsistent disclosure policies among regulators. The Commission would oversee the full and accurate disclosure of financial information by depository institutions to the investing public. Needless gaps in investor protections would be avoided, and the agency with the greatest expertise would assure that bank investors receive the same protections enjoyed by investors in telecommunications, computers, chemicals, energy, transportation and every other type of business. Raising capital should also become less

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33/ In order simply to find the reports of a particular financial institution under the current system, investors must first know the institution's organizational structure and details of its business operation -- for example, whether it is owned by a holding company or not, whether it is a bank or a thrift, whether it is a state bank or a national bank, and whether it is a member of the Federal Reserve System or a non-member.

costly for banks when accurate, comparable financial information about bank issuers is as readily available as is information concerning the 11,000 other publicly-held companies subject to the Exchange Act.

IV. Conclusion

Banks are becoming an increasingly important component of our securities markets. Outmoded statutory exclusions, however, keep bank securities activities outside the proven regulatory system established under the federal securities laws. As a result, the Commission cannot supervise or regulate a significant and growing sector of the securities industry.

This is a serious impediment. As the regulator charged with oversight of the securities industry and the maintenance of fair and orderly markets, the Commission must have a comprehensive view of those markets and their participants. Due to the bank exclusions, however, the Commission has access to only a partial view of the securities markets. Since effective regulation plays a significant role in the success of the U.S. equity capital markets, this gap in the regulatory structure could have serious consequences for our economy as a whole.

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For all these reasons, increased bank securities activities -- and the most recent and dramatic example of this trend, the proposed Mellon/Dreyfus merger -- underscore the need for legislation to enhance the existing regulatory framework. H.R. 3447 would significantly enhance investor protection and rationalize the regulation of bank securities activities. The bill provides a blueprint for implementing the principles of functional regulation and providing investor protection in the context of bank securities activities. The Commission is pleased to reiterate its support for H.R. 3447, and to urge prompt enactment of its provisions.

Mr. DINGELL. Mr. Levitt, we thank you for your very helpful statement.

Mr. Barbash, we would inquire, do you have any comments you would like to add to the very excellent statement made by Mr. Levitt?

Mr. BARBASH. Not at this time.

Mr. DINGELL. Very well. We hope you will feel free to discuss with us any matters of concern that you might feel would be appropriate.

First, the Chair would like to do a little housekeeping business.

Chairman Levitt, your testimony presents a strong case for repealing bank broker-dealer and investment advisory exemptions within the Federal securities laws in order to apply a predictable and consistent scheme of securities regulation across the board for the protection of investors. No one doubts the sincerity of your commitment to carrying out any additional and appropriate regulatory responsibilities, but concerns have been raised about whether you have adequate staff and budget resources to do a larger job.

According to your fiscal year 1995 budget estimate, in calendar year 1992, a total of 8,201 broker-dealer firms were registered with the SEC. These firms had approximately 34,000 branch offices and 427,000 registered representatives.

Over 2,500 new investment company portfolios were created in 1993, bringing the total to 21,200 portfolios with assets under management of approximately $2.4 trillion. Mutual fund assets alone stood at $1.9 trillion at the end of fiscal 1993. The number of registered investment advisers stands at 20,000.

At the end of 1993, total assets under management were approximately $9.6 trillion, an increase of over 18.5 percent over the prior year. At current staffing levels, your inspection cycle for investment advisers is once every 27 to 30 years.

The Comptroller of the Currency contends that his bank examination staff greatly out-numbers your inspection staff, and that bank examiners are constantly in depository institutions and can do a better job. He therefore argues that bank regulators are better equipped to oversee bank securities activities and to examine for compliance with applicable laws.

Can you give us your response to those comments, please?

Mr. LEVITT. Yes. I think this, as so many other issues that we are dealing with today, deals with the history and the purpose of the various regulatory organizations that are involved in this process.

The SEC is primarily, overwhelmingly, compellingly committed to investor protection. The banking regulators have as their principal mandate the safety and soundness of the banks.

Mr. DINGELL. Now, you've said something. You said the safety and soundness of the bank. You did not refer to any investor protection opportunities at all or responsibilities.

Mr. LEVITT. It is a question of priority. Undoubtedly, every regulator is concerned about various levels of protection, but clearly the history of banking regulation has been to protect banks, and to provide a level of secrecy in that process.

The SEC, on the other hand, depends upon open disclosure, upon full information in terms of protecting their principal client, the in-

vestor. So that is a very fundamental difference between the two, and to carry out our regulatory responsibilities, we approach our tasks with different levels of passion directed at our respective constituents.

Now, when you talk about the multiplicity of investment advisers, I would draw the distinction between advisers who operate on their own—so-called freestanding advisers including financial planners, which are the bulk of the advisory community—and advisers to investment companies.

We are talking in this instance about mutual funds, about investment companies. We are already in the banks; we are already inspecting those registered funds, but we are not able to inspect the banks that are advising those funds.

It is as if we are operating with one hand tied behind our backs—inspecting one element, and not inspecting a very critical other part of that element.

Mr. DINGELL. Now, I want to emphasize one thing that you have said to us. You said you are in there examining the funds, you have that power?

Mr. LEVITT. Yes.

Mr. DINGELL. But you do not have the power to look at the recommendations, the financial advice and so forth, that the sellers of these funds, the dealers in these funds, are giving to the buyers. Is that right?

Mr. LEVITT. That is correct.

Mr. DINGELL. Why not?

Mr. LEVITT. Well, the banks are excluded from our inspection activities by law.

Mr. BARBASH. That is true. Banks, as investment advisers are not covered by the Investment Advisers Act, and our jurisdiction does not cover them when they act in that capacity.

Mr. DINGELL. I want you to continue on your comment, please, Mr. Levitt, but just in order to get this thing in perspective, would I be fair in observing that you have certain other powers over those who are regulated by you? You are able to address conflicts of interest, you are able to address bad advice, you are able to address questions like frontrunning, you are able to address questions like insider trading and trading for an individual's own account, and you are able to require paper trails to be kept by investment advisers and by people who operate mutual funds and so forth when they are under your jurisdiction, but not when they function under the bank exemption. Now, is that a fair statement?

Mr. LEVITT. That is a fair statement, and we have enforcement activities that are fundamental to protecting the investor. That is not a tradition that our fellow regulators are able to embrace in terms of what we are discussing now.

Mr. DINGELL. You also have the assistance of your self-regulatory organizations, SRO's, which function as regulators under the regulatory responsibilities of the SEC. Is that not right?

Mr. LEVITT. That partnership is critically important, and it also goes to the issue of training and supervising individuals who are responsible for marketing those mutual funds.

Mr. DINGELL. Now do you have any jurisdiction to address the question of the trading of the operators or dealers or advisers of mutual funds when they are regulated by the bank regulators?

Mr. LEVITT. We have authority to supervise the training of those registered broker-dealers who may be part of a bank's selling operation, but those bank employees who are not registered with us—and I have reason to believe that there are a substantial number of them—we have no responsibility to supervise their selling activities.

Mr. DINGELL. So then who is it that is protecting against conflicts of interest, frontrunning, lack of paper trails, self-dealing, conflicts of interest and questions of that sort, in the case of the mutual funds which are regulated by the bank regulators?

Mr. LEVITT. In fairness to our fellow regulators, they have outlined a series of recommendations or guidelines to protect against the kinds of abuses that we have been discussing, and Comptroller Ludwig has made a number of very hard-hitting and I think effective speeches in terms of what banks should or should not do. But I hasten to say that the regulatory mechanism, the enforcement devices which I believe are critical to the success of the SEC in this regard, comes as a result of a history and comes as a result of a setting priorities which is simply not present in terms of bank activities.

Mr. DINGELL. Is it also fair to say though that the guidelines that they have set forth are voluntary and are not mandatory in character?

Mr. LEVITT. That is the case at the present time.

Mr. DINGELL. All right. Now what is the enforcement mechanism which they would set forward then to assure that these—I want to stress this word—voluntary——

Mr. LEVITT. I am not aware of any specific enforcement mechanism.

Mr. DINGELL. Do they have any tools whatsoever available to them? Have any regulations been issued by the bank regulators for the enforcement of these protections?

Mr. LEVITT. I am not aware of any, but perhaps Mr. Barbash may be able to supplement.

Mr. DINGELL. As a matter of fact, I just was noting here that the banks seem to be functioning under this set of words. They say "The failure of a depository institution to establish and observe appropriate policies and procedures consistent with this statement in connection with sales activities involving non-deposit investment products will be subject to criticism and appropriate corrective action."

What does that mean?

Mr. LEVITT. Whiplashing by tongue.

Mr. DINGELL. Could we say: "You've been a bad boy, you can stand in the corner"?

Mr. LEVITT. At least.

Mr. DINGELL. "We will cut your lunch hour"?

Now the transactions, however, with regard to these matters are now going on at a high rate of speed and they are increasing every year, are they not?

Mr. LEVITT. It's proliferating. Many individuals who have seen the rate of return on their deposits diminish have been taking their money and putting it into mutual funds—many of which are sponsored and sold by banks—in the belief that they have a measure of security by virtue of the fact that those banks are selling the mutual funds. They believe that that gives them a certain kind of protection, whether it is FDIC protection or merely the circumstance that a bank is selling it gives that fund a certain imprimatur, a certain standing in the minds of an unsophisticated investor. I believe this creates a dangerous misperception.

Mr. DINGELL. Thank you. The Chair notes my time has expired. I am going to recognize my colleagues for questions and then I will again recognize myself in appropriate order.

The Chair recognizes now my good friend from Colorado, Mr. Schaefer.

Mr. SCHAEFER. Thank you, Mr. Chairman. Mr. Levitt, Mr. Barbash, I'm glad to have you here today to try and clear up a few of these concerns that we have on this merger.

Now let me ask you a question. Most bank deposits, as we all know, are insured by the FDIC. Securities accounts are insured by the Securities Investor Protection Corporation.

Now how do these two forms of insurance differ when we talk about the Securities Protection Corporation and FDIC?

Mr. LEVITT. Well, the FDIC protects accounts against loss. If you as a depositor put $10,000 in your bank, you would know that at any time you can get $10,000 back. SIPC protects, up to a certain amount, money and securities that may be held by a brokerage firm. It doesn't protect whether those securities will be up or down in value. It merely protects the existence of those securities.

Mr. SCHAEFER. You said a certain amount?

Mr. LEVITT. Yes. What is the SIPC protection now?

Mr. BARBASH. I forget exactly what the number is SIPC covers.

Mr. LEVITT. It's up to $100,000 for cash.

Mr. SCHAEFER. Up to $100,000?

Mr. LEVITT. Yes.

Mr. BARBASH. It covers the value of your securities should the brokerage company suffer a failure so that you will have your securities returned to you. It's a different form of insurance.

Mr. SCHAEFER. All right. I guess maybe I am not completely clear on this. We know FDIC, what it protects. Now how do they go to—automatically? Do they have to apply for this $100,000 insurance?

Mr. LEVITT. Are you talking about SIPC?

Mr. SCHAEFER. Yes.

Mr. LEVITT. If a firm fails, SIPC has to decide that it really has failed. The individuals then petition SIPC to secure return of their securities. Usually we are talking about return of securities, sometimes cash. That takes a period of time, and then SIPC returns the money up to the extent of their ability. SIPC has always made good on this and they are stronger today than they have ever been.

Mr. SCHAEFER. But it's on only fraud cases, is that correct?

Mr. LEVITT. No, it's if a firm just goes broke, SIPC will stand behind it.

Mr. BARBASH. Many investors seem to have a problem understanding SIPC. They believe that SIPC would protect the value of their investment from going down, which it does not. In other words some people have the feeling that when they make an investment in a particular mutual fund that their return would be guaranteed somehow by SIPC coverage, but it is not that kind of insurance.

We did a series of focus groups with investors, and we found SIPC was one of the more difficult points for investors to understand. We are seeking to deal with that problem through disclosure and other consumer aids.

Mr. SCHAEFER. SIPC must show fraud on the part of the broker before the investor gets his money back, is that correct?

Mr. BARBASH. No.

Mr. LEVITT. If Brokerage Firm A made some bad judgments and went broke, not through fraud but just bad market judgment, let us say, the investors would be protected up to $500,000 in terms of their investments of cash and securities that were held by that firm.

You want to be certain that those securities will be returned to you, and that is the kind of instance where SIPC comes into play.

Mr. SCHAEFER. Is it possible that people who buy securities at a bank confuse the FDIC with SIPC? Is this pretty clear or is there confusion out there?

Mr. LEVITT. Our surveys and surveys conducted by other groups around the country tend to convince me that the vast number of new individuals who have never before owned securities and are moving into mutual funds being sold by banks are confused by what kinds of protection they get. It is my conviction that a bank carries with it a certain imprimatur in this country, particularly to unsophisticated investors who have had their deposits there, who have been receiving regular returns on those deposits, and who have gotten back every penny that they have put in.

They believe that something that is sold by that bank carries a guarantee that is not carried by a brokerage firm or a mutual fund company.

Mr. SCHAEFER. And they don't know really whether it is SIPC or FDIC. They just know——

Mr. LEVITT. They just think they are going to get it back.

Mr. SCHAEFER. Something back.

Mr. LEVITT. And if you compound that with, and I don't wish to complicate this, investors who have purchased bond funds, again the notion of a bond in the minds of unsophisticated investors I believe is it's a bond, it's a first call, you can't lose money on it—so I think there is an educational job that has to be done and indeed is being done.

Mr. SCHAEFER. Because they are advertising in both cases, usually in a bank, and the consumer, if he is not knowledgeable, will not know what he has entered.

Mr. LEVITT. When the names are so similar—and I have seen well over 300 names of mutual funds sponsored by banks that if they are not exactly the same—they are so close that an investor certainly could believe that this is a product that carries the full

backing, full imprimatur of the bank, that stands behind it in their minds.

Mr. SCHAEFER. On the Mellon-Dreyfus merger, is this somewhat unique or is there anything about this particular merger that we should have special pause to think about?

Mr. LEVITT. Like so many things in our financial markets, I suspect that this is the beginning of a process. It is fuelled by competition. It is fuelled by problems that banks have experienced in terms of earnings, and I think what we are seeing now is probably the beginning of a rush of such kinds of mergers.

I think that parties to this particular transaction are certainly mindful of the problems that we have been talking about, and they are trying to structure this arrangement in a way which would be responsive to that, but there is no guarantee in cement.

Does that say what the next competitive acquisition will bring? Generally speaking, the first out of the gate are the ones that are the most secure, the most responsible, the most conforming to what they think our concern will be. But after that, when the rush comes from the gate, when there are 20 funds about to be acquired by different banks around the country, will we be able to focus the kind of laser-like attention on these problems that we are today?

I don't think so, and that's why I feel so strongly about the need for functional regulation, which brings a measure of consistency to this process and helps clarify the dreadful perceptions that I think are so dangerous out there.

Mr. SCHAEFER. It seems to me it is almost like initial mergers like U.S. West/Time-Warner, McCall/AT&T, Jones Intercable, and Canada Bell. I mean it's certainly not the same but the initial start was there on these mergers and so this is the initial start here on this kind of merger.

Mr. LEVITT. You're right. It rarely exists in a vacuum, and I don't think this one will either.

Mr. SCHAEFER. Thank you, Mr. Levitt and Mr. Barbash.

Mr. DINGELL. The Chair thanks the gentleman.

The gentlewoman from Pennsylvania.

Ms. MARGOLIES-MEZVINSKY. Thank you. Mr. Levitt, if you could be a little bit more specific, what are your fears after this initial rush, after this initial—what you said were perhaps the most responsible of mergers, down the pike?

Mr. LEVITT. I guess I fear the fragmentation of the regulatory process in a way that will allow many innocent Americans to be badly hurt in the process. Now what I mean by that is that the SEC has a history of anticipating monitoring and punishing individuals who take advantage of our securities activities.

Our emphasis, and I can't say it too often, is on investor protection. I don't know what the banking regulators will bring to the table in this regard, but I know that they lack the experience in terms of training, and a history of regulatory oversight in these areas. That's not something that you gain by reading a manual, and it is not something that you come by easily. It is something that is born through a history of experience.

I thought that I had seen every possible mischief-maker in the business in my 20 years in the securities industry. Since I came to the Commission, I have seen many more than I ever saw before in

my whole life. To expect a banking regulator, whose first and foremost concern is that banks must be able to open their doors tomorrow morning, to do the kinds of things that a securities regulator would do I think is not realistic, and I think when there is the inevitable conflict between the interest of the bank, the interest of the depositors, and the interest of the shareholders, of the owners of shares in the mutual funds, in my judgment, the bank regulators will come down in favor of the former rather than the latter, and that is my greatest concern.

Ms. MARGOLIES-MEZVINSKY. How many Mellon-Dreyfus type deals currently exist?

Mr. LEVITT. How many do I anticipate?

Ms. MARGOLIES-MEZVINSKY. Currently exist now.

Mr. LEVITT. None exist to this extent. This is by far and away the largest. Mellon has also acquired the Boston Company, which is part of their overall complex and a number of banks have mutual funds but none comes close to this size.

Mr. BARBASH. This deal will cause Mellon to be the largest bank mutual fund complex by four times over the next largest.

Ms. MARGOLIES-MEZVINSKY. How many situations currently exist whereby a securities entity is owned outright by a bank?

Mr. LEVITT. I don't know exactly the number of banks that sell securities. There are approximately 30 bank holding companies that have securities affiliates, so-called section 20 affiliates. But there are an increasing number, in the hundreds, of banks that market mutual funds that they either own or mutual funds that are networked.

In other words, an arrangement that is very frequently employed is a mutual fund company will come to a bank and say we'll put our people in all of your branches and we'll sell our funds through your branches and perhaps you'll have some of your sales people sell our funds in your branches.

Ms. MARGOLIES-MEZVINSKY. But that is very different. Do you anticipate that many more will come?

Mr. BARBASH. To answer your question from before, there's around 110 banks or their subsidiaries who are involved in the mutual fund business at this point.

In terms of whether we anticipate whether others will come, that is hard to say. We are surely seeing consolidation in the mutual fund area generally.

Mr. LEVITT. I think that every mutual fund, major mutual fund complex, seeing what Dreyfus has obtained in this transaction, will give serious thought to affiliation with a bank and every bank or many banks in America, seeing that one of their competitors has developed a means of diversifying their revenue stream against the problems that have afflicted banks in recent years will be looking for this exact same kind of transaction.

The history of American investment banking and the mergers and acquisitions business shows you that these things rarely occur in a vacuum. They occur as part of an overall pattern, and that pattern, I assure you, will exist in this instance as well.

Ms. MARGOLIES-MEZVINSKY. Could you just address some of the tools that are available to protect investors? Can you elaborate a little bit more specifically about those tools that are available to

the regulators to ensure that banks don't mislead their investors in a banking setting?

Mr. LEVITT. Well, I think that, first and foremost, the self-regulatory mechanism employed in the securities field is fundamental to the area of supervision. The fact that there are exchanges and an NASD out there that will conduct inspections that will bring to the Commission the attention of various kinds of malfeasance, I think, is critically important.

I think the training of salespeople is also a critical factor. Right now, every salesperson who sells a security or sells a bond must be trained, and takes a so-called section 7 examination. Because the number of products has proliferated so much in recent years, the Commission is actively working on a plan together with the NASD and a committee that they have formed to upgrade that training so that brokers must be requalified on a regular, ongoing basis and retrained on a periodic basis. That is terribly important.

The enforcement mechanism that the Commission applies—a history of enforcement which is probably the finest deterrent, the most effective deterrent imaginable—is another method that the Commission has uniquely applied to the securities industry. I can assure you that securities problems are very special and very different from the kinds of problems that you would experience in the ordinary conducting the affairs of a bank.

Maybe an overarching support for the kind of regulation and supervision that I am talking about is the discipline of the marketplace, a discipline that holds accountable every transaction that takes place in a securities firm, and simply is not the case in terms of bank regulation. I believe if you substituted a bank regulator who was experienced in looking at the kinds of things they look at for a securities regulator, you simply would be applying a set of standards that are very, very different and very much less effective in my judgment for the specialized kind of regulation involved in the securities industry.

Ms. MARGOLIES-MEZVINSKY. Thank you, Mr. Levitt. Thank you, Mr. Chair, thank you.

Mr. DINGELL. The Chair thanks the gentlewoman.

Chairman Levitt, later today I am going to be transmitting to the SEC and to the four Federal bank regulators a 55-page table comparison of the regulation of broker-dealers and investment advisers under the Federal securities laws versus under the banking laws.

I will be keeping this hearing record open for 30 days to allow all of the recipients of that document to review it with care and to submit any corrections that are needed.

Even in draft form, however, it points out glaring differences in substance and in approach and significant shortfalls in the protection of investors under banking laws. [See p. 906.]

Would you please outline some of the material differences in those regulatory systems for us?

Mr. LEVITT. Yes, sir. In the first place, securities' broker-dealers all must register with the Commission. Banks don't register. Even the FDIC doesn't know how many or exactly which banks are involved in securities activities.

Second, SEC registered broker-dealers are, as I mentioned before, subject to uniform comprehensive testing and qualification

standards administered by the SRO's and the process is now underway to develop a plan of continuing, ongoing qualification training as well as continuing ongoing testing. Bank employees are simply not subjected at this present time to uniform testing and qualification requirements. Every bank does its own training and it varies a great deal from bank to bank.

Broker-dealers I think importantly, are subject to comprehensive regulatory planning and a strong enforcement program. The banks right now are subject only to guidelines. As far as I know, they are not enforceable by the bank regulators, and a bank enforcement program simply does not focus on investor protection.

Another more subtle kind of difference, I think, is the fact that banks really don't have an explicit duty to supervise. So many cases of the Commission involve failure to supervise. It is really the front line of how we have brokers adhere to standards that are important in terms of investor protection.

Under SEC regulation, broker-dealers have a duty to supervise, principals and supervisors are separately examined, and we hold those supervisors responsible for the performance of the vast network of brokers that fall beneath them. This is a very fundamental difference, in my judgment.

Mr. DINGELL. Now let's go into a little hypothetical.

For purposes of this, you will have to imagine that I am not the Chairman of the Oversight Subcommittee——

Mr. LEVITT. Unimaginable.

Mr. DINGELL. Instead I am Mrs. Innocent Consumer. My middle name is Guileless. I am a widow of 72 years of age and I just lost my husband of 50 years, who managed the affairs of the family, financial and otherwise. Now our family has been banking at Rock Solid Bank for 30 years and 1 day I go down to good old Rock Solid to check the balance in my account and find out what my financial situation is.

I go in to talk to the first available teller but, as I do so, I note that the name over the door has been changed to Financial Services-R-Us. I walk to the first available teller for the balance in my savings account and for the status of my CD and he calls the information up on his computer and writes it down on a piece of paper which he hands to me, and he says: "Ms. Consumer, you are one of our best and most treasured customers. I feel compelled to tell you that you could be earning a lot more interest if your money was in one of our investment products. I think you should talk to one of our salespeople about making a bigger return here." He sends me just down the hall to his associate, Mr. Frank Sly.

Now Mr. Sly has signs all over his desk, one of which is an FDIC logo with a line through it, a picture of a bank with a line through it, and a picture of a passbook with a line through it. Now goodhearted Mr. Sly tells me that I should put all my retirement money and all of the insurance that I got from my husband into mutual funds and he tells me that they are not insured by FDIC but that FDIC insurance is only up to $100,000 and these investments carry SIPC insurance of a half a million dollars plus there is a private insurance policy. This is something that comes out of another bank's advertisement—I won't tell you which one although we might have them before us to discuss it with us—and it says down

here, it says Protection Insurance—SIPC, Securities Investment Protection Corporation including $100,000 in cash, up to $500,000. Then it says Equitable Casualty and Surety Company, $9.5 million, total coverage $10 million. And he says "You are only insured up to $100,000 by FDIC."

So dear Mr. Sly discusses the broad array of funds available and tells me that I would be a fool to pass up a hot emerging market fund and a sizzling Ginnie Mae bond fund.

Now being somewhat new to financial affairs, I express concerns about some of the countries and companies in the emerging market fund. I also ask him whether Mr. Greenspan's testimony about the direction of interest rates has had any impact on bond funds.

Now dear Mr. Sly looks hurt and I am touched and he reminds me that Rock Solid has always been there with me, and he writes on the brochure for the Ginnie Mae bond fund the number 13.8 percent. Now I am only getting about 2.7 percent on my CD, and this looks pretty good, and he tells me that return is guaranteed and bonds are safer than stocks.

I sign a whole pile of forms which are presented to me and I don't really understand these. I have never seen forms like these before anyhow, and I am not really given much time to read these forms, which are rich in fine print, as you might imagine.

When I received my first account statements, I had a mild heart attack. I find out for the first time that I paid a huge front-end load on the sale. I also find that the market on each of the two funds—the hot emerging market fund and this red-hot sizzling Ginnie Mae bond fund—they both had undergone a very sharp drop in price, in value. I find that a major part of my principal has been lost.

So I rushed down to Financial Services-R-Us, which used to be Rock Solid Bank, and find a long line of customers who are there screaming for dear Mr. Frank Sly and for Mr. Frank Sly's supervisor.

Now, we find out that Mr. Frank Sly is on a long, extended holiday in South America, in Brazil to be exact, which happens to have, I note, no extradition laws with the United States, and that his supervisor is out of the office for a very long lunch, which began sometime last week.

Now, what are my rights and remedies here under the banking laws?

Mr. LEVITT. Very few.

Mr. DINGELL. Very few. Why do you say that? What can I get under the banking laws?

Mr. LEVITT. You would not be protected by SIPC because SIPC doesn't protect mutual funds, it protects securities.

Mr. DINGELL. But I have this wonderful ad here which has been put out by a bank, and, in fact, has been done so, telling me how I am protected up to $10 million. Do you mean to say I am not going to be protected by that?

Mr. LEVITT. Precisely.

Mr. DINGELL. Now, do I have a private right of action against either Mr. Frank Sly or the bank?

Mr. LEVITT. I suspect in the case of fraud you probably—you might have a private right of action.

Mr. DINGELL. But I don't have the private right of action that I would have under the securities laws; do I?

Mr. LEVITT. No. I think that I would be very specific.

Mr. DINGELL. Nor do I have the right to arbitration; do I?

Mr. LEVITT. You have no right to arbitration.

Mr. DINGELL. Under the securities laws, I would have the private right of action, and I would also have a right to arbitration; would I not?

Mr. LEVITT. Absolutely. I should have mentioned that before, that the right of arbitration is a terribly important protection for the investor.

Mr. DINGELL. Now, it is also fair to observe that under the securities laws I am supposed to be given a prospectus; am I not?

Mr. LEVITT. That is correct.

Mr. DINGELL. Now, I have not been given a prospectus. Is that a violation?

Mr. LEVITT. Under the securities law?

Mr. DINGELL. Yes.

Mr. LEVITT. Yes.

Mr. DINGELL. It would be a violation of the securities laws, but am I protected against refusal or failure to give me a prospectus here by the bank?

Mr. LEVITT. No.

Mr. DINGELL. I'm not. Now, is there a requirement for suitability? In other words, do the bank laws and the bank regulators require that a 72-year-old widow who has just lost her husband be steered to appropriate investments, or be given a hot sizzling Ginnie Mae fund and a red hot emerging market fund?

Mr. LEVITT. Under the present circumstance, the only guide in that direction is the guidelines that the various banking regulators have initiated and discussed, but they have no more force than guidelines would have.

Mr. DINGELL. These have no force and effect in law; do they?

Mr. LEVITT. Absolutely not.

Mr. BARBASH. Your investor in your situation has many more fully defined rights under the securities laws. You can come up with theories. She probably would have a right under 10(b) against the bank person in that situation.

But in terms of having a suitability requirement that is clear under NASD rules and the Stock Exchange, the right is much clearer.

Mr. DINGELL. Well, let's address this. As of this particular minute, I haven't seen any fraud. All I have seen is that they have given me this wonderful statement about how I am going to be protected. Now, does that constitute fraud?

Mr. LEVITT. You would have a tough time, in my judgment.

Mr. DINGELL. I assume I would get a great deal of sympathy, but not relief from the banking regulators; is that right?

Mr. LEVITT. You would get much more from the securities regulators.

Mr. BARBASH. The problem with respect to that ad is that when you analyze it from a fraud perspective, most everything that you would need to say is in there. It is just in there presented in such a way as to not be particularly clear to the investor. So, the inves-

tor would likely come away with the feeling that your investor had in your situation.

Mr. DINGELL. Well, the practices in the Securities and Exchange Commission are essentially consumer protection, or, "Let the seller beware." It appears that here at good old Rock Solid Bank, Mr. Sly has had me under a new set of rules which are, "Let the buyer beware"; is that right?

Mr. LEVITT. It is, and if I might briefly comment on another example of how that comes to bear, it is not infrequent where, under certain circumstances, if an investment company has a problem, the independent investment adviser—in the case of money market funds in particular—might help bail them out.

Now, let us hypothesize that a bank mutual fund had a problem. I doubt that the banking regulators would very likely allow the bank adviser to perform a similar amount of assistance to that bank mutual fund.

Mr. DINGELL. Wait. You say it would allow them to provide assistance?

Mr. LEVITT. I doubt that the banking regulators would allow the bank serving as an adviser to a bank mutual fund that made an investment that didn't work out, to help that fund in the same way——

Mr. DINGELL. In other words, to bail out that fund for the protection of the investors?

Mr. LEVITT. Yes, because the bank regulator is concerned primarily with the protection of the bank, not the investor.

Mr. DINGELL. All right. Now, let's say that one of the reasons that the value of the sizzling red hot emerging market fund fell was frontrunning, fraud, or insider trading—would there be, first of all, a requirement for a paper trail under bank regulation?

Mr. LEVITT. I don't believe so.

Mr. DINGELL. Is there, Mr. Barbash?

Mr. BARBASH. A paper trail in terms of watching for frontrunning——

Mr. DINGELL. Of knowing at the time that the different deals were consummated, what the interest was? Let's take frontrunning where you know that you've got a deal. So, you run in and you buy or sell for yourself before the deal is consummated because you know that the market is going to be affected.

Mr. BARBASH. There are requirements under the securities laws, under the Investment Company Act, that would cover the bank mutual fund the way that they would cover any other registered investment company that would be designed to bring to light frontrunning possibilities.

There is a code of ethics requirement and reporting requirement that would, at least, put information into the record for our inspectors when they inspect the fund to see evidence of frontrunning.

Mr. LEVITT. We couldn't go beyond the fund. We couldn't go to inspect the bank itself to pursue such a case without a subpoena.

Mr. BARBASH. That's a very good point. When you seek to make a frontrunning type of case, typically what would happen is, you would compare the records of the mutual fund with the other records of the adviser to the mutual fund.

Mr. DINGELL. So, you can't compare, then, the records of the mutual fund against the records of the advisers?

Mr. BARBASH. That's right.

Mr. DINGELL. Now, what would that kind of comparison tell you?

Mr. BARBASH. Well, in a case where you had frontrunning, you would be able to see where the adviser made trades in the same securities where he made trades for the fund. You could compare and see who got the better trades under what circumstances, whereas if you don't have the records of the adviser, it is virtually impossible to make that kind of a case.

Mr. DINGELL. So you would have no way, then, of gathering that particular evidence by that particular kind of comparison?

Mr. BARBASH. Unless there was some kind of voluntary provision of the information.

Mr. DINGELL. Is there such a thing now?

Mr. BARBASH. We can always ask, but there is no channel for getting it.

Mr. DINGELL. So what you are saying, then, is to protect poor old Mrs. Consumer, you have to go hat-in-hand to the bank regulators and say, "Dear Bank Regulators, the SEC is trying to protect consumers. Would you cooperate with us in this matter?"

Is there any requirement out there that they shall do so?

Mr. BARBASH. It is true that we basically——

Mr. DINGELL. They can tell you to go to hell; can't they?

Mr. BARBASH. They can do that. As the chairman said before, we are in a situation where we would have to rely on personal relationships and good will among regulators, which could be good at one point and not so great later.

Mr. DINGELL. Remembering at all times that they are functioning under this wonderful voluntary set of arrangements which may or may not compel the banks or the securities dealers and others who are functioning under the exemptions; is that right?

Mr. BARBASH. Yes.

Mr. DINGELL. Now, let's look here at a couple of other interesting questions. We are talking about compliance in your statement. This is a joint statement of the bank regulators.

It says as follows: "6. Depository institutions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations."

Now, what applicable laws and regulations would they be conducted with?

Mr. BARBASH. Well, presumably they would be looking to the securities laws for some guidance.

Mr. DINGELL. But it doesn't say that there; does it?

Mr. BARBASH. No, it doesn't.

Mr. DINGELL. It doesn't spell out the policies and procedures; does it?

Mr. LEVITT. No.

Mr. DINGELL. Now, it goes on to say a little further on that, "The compliance procedure should also provide for a system to monitor customer complaints and their resolution."

Is there anything of this kind that is apparent to you?

Mr. LEVITT. Well, that system is a critically important one. I don't think there is any substitute for the arbitration procedures that exist.

Mr. DINGELL. They go on to say, "Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the depository institution."

What does that mean?

Mr. LEVITT. It means that there could be 65 different kinds of agreements based on all kinds of different local considerations. It means that we have a lack of consistency in this regard that I think is wrong.

Mr. BARBASH. It also puts in an overlay on existing regulation. Presumably any broker-dealer that entered into an agreement would be already subject to NASD rules and now would have this overlay on whatever was in that agreement.

Mr. DINGELL. Now, let's just look at this little thing here that we have. When the SEC is going to do something which relates to regulation, or issuing of regulations, you have to put it out for notice and comment; don't you?

Mr. LEVITT. Yes.

Mr. DINGELL. Then you have to hear what the comments are; isn't that right?

Mr. LEVITT. That's correct.

Mr. DINGELL. You have to wait a while, like 30 days, to 60 days, maybe 120 days, right?

Mr. LEVITT. Yes.

Mr. DINGELL. Then the comments come in. Then you have to have an official proceeding on those comments; don't you?

Mr. LEVITT. That's correct.

Mr. DINGELL. Unless you have gotten no comments? But you always do get comments?

Mr. LEVITT. Always.

Mr. DINGELL. Then you have to have a hearing; isn't that right?

Mr. LEVITT. Yes.

Mr. DINGELL. This is required of you by the Administrative Procedures Act and by the requirements of the Constitution; isn't it?

Mr. LEVITT. Yes.

Mr. DINGELL. You are required then also to have a meeting of the SEC and to make a decision on the record; is that not so?

Mr. LEVITT. That is correct.

Mr. DINGELL. Now, are the bank regulators compelled to meet a similar set of public interest standards in which the matters are made open and available and in which they function in the broad light of day, using as Justice Brandeis once said, "The sunlight, which is the best of all disinfectants"?

Mr. LEVITT. I am not aware of any such procedure.

Mr. DINGELL. Do you think we ought to ask them about that tomorrow when they come in?

Well, let's just ask one last question. What would happen if good old Frank Sly, who is now enjoying himself down in Brazil, were an SEC-registered broker-dealer, and so was Financial Services-R-Us? What would the rights of poor old Mrs. Consumer be?

Mr. LEVITT. I think she would have a right of rescission. We would go after them. I think it is 29(b) that would enable her to, if this was found to be fraudently sold under our provisions, she would have a right to get her money back. If that was not possible, we would certainly go after him and the rest of that group.

Mr. DINGELL. You would go after not only dear Mr. Sly, but you would also go after good old Rock Solid, which is now Financial Services-R-Us, right?

Mr. LEVITT. Absolutely.

Mr. DINGELL. What would you be able to do to them about the kind of misbehavior that we have now seen if there was frontrunning, there was fraud, there was insider dealings, and there was a lack of a paper trail. There was apparently a failure to properly supervise. What would you be able to do here?

Mr. LEVITT. If all of those elements existed, we could fine them, censure them, kick them out of the business.

Mr. DINGELL. And perhaps refer the matter to the U.S. Attorney?

Mr. LEVITT. And perhaps refer it to the U.S. Attorney.

Mr. DINGELL. Who might send them off for a comfortable period of sojourn at some appropriate Federal institution; isn't that right?

Mr. LEVITT. Yes, sir.

Mr. DINGELL. Would those things happen to dear Mr. Sly, who is now enjoying himself down in the warmth of sunny Brazil?

Mr. LEVITT. Probably not.

Mr. DINGELL. These things do constitute also felonies under the securities laws; do they not?

Mr. LEVITT. Yes, sir.

Mr. DINGELL. But they do not constitute felonies under the banking laws; do they?

Mr. LEVITT. No.

Mr. DINGELL. Imagine that. Now, let's just assume that there was a pleasant little conspiracy between Mr. Sly and his superiors in the bank. They were all together in this wonderful little arrangement of getting poor old Mrs. Consumer. Maybe Aunt Minnie Peagreen, they would get her, too. They have gotten a whole bunch of guileless innocent folks that they had caught. Would the conspiracy laws apply here?

Mr. LEVITT. It's possible.

Mr. DINGELL. Possibly. Now, do the bank regulators have any kind of an enforcement mechanism like you have to catch this kind of behavior?

Mr. BARBASH. The enforcement mechanism is——

Mr. DINGELL. Do they have any kind of thing that lets them note perhaps some remarkable trading events which might occur because we might find that Mr. Sly and his boss had been trading and had all of a sudden dumped or bought large amounts of securities which happened to be held by this red hot sizzling emerging market fund.

Do they have any kind of device to enable them to do that sort of thing at the bank regulatory agencies?

Mr. LEVITT. I'm not aware of it.

Mr. DINGELL. So they would be sitting there just thinking, "What a wonderful thing good old Rock Solid is and what a wonderful

thing Financial Services-R-Us is doing in terms of moving forward the interest of the American banking industry"; isn't that right?

Now, I assume that they would be very, very happy. They might even go to a dinner at which the matter of how Financial Services-R-Us has moved into the new wave in the financial markets and has begun this process of reforming all the stodgy old ways that we have seen in this industry under the unfortunate administration of the SEC.

We might even see the Comptroller of the Currency or somebody like that up there to say, "We are now moving forward to restore the solidity of the American banking institutions." That is possible; isn't it?

Mr. LEVITT. Yes.

Mr. DINGELL. Well, it is an interesting prospect.

My time has expired. The Chair recognizes the distinguished gentleman from Colorado.

Mr. SCHAEFER. No questions, Mr. Chairman.

Mr. DINGELL. OK. Mr. Levitt, if the OCC were to approve the Mellon-Dreyfus transaction—and I want us to forget now at least temporarily poor old Mrs. Consumer at good old Rock Solid and the other institutions we have been discussing.

If OCC were to approve the Mellon-Dreyfus transaction, Dreyfus would continue to be subject to an array of Federal securities laws and regulations; would it not?

Mr. LEVITT. Yes.

Mr. DINGELL. Now, as a registered broker-dealer, Dreyfus would be regulated under the Securities Exchange Act of 1934; isn't that right?

Mr. LEVITT. Yes.

Mr. DINGELL. Under the NASD rules of fair practice; is that right?

Mr. LEVITT. Yes.

Mr. DINGELL. And subject to SEC and NASD oversight; is that right?

Mr. LEVITT. Yes.

Mr. DINGELL. Now, as an investment adviser to mutual funds, Dreyfus also would be required to comply with the Investment Company Act and the Investment Advisers Act; would it not?

Mr. LEVITT. Yes.

Mr. DINGELL. Exemptions from the Investment Advisers Act available to national banks do not apply to operating subsidiaries and would not apply to Dreyfus; would they?

Mr. LEVITT. No.

Mr. DINGELL. Now, in addition the OCC advises us that Dreyfus would be required to comply with all laws applicable to national banks and would be subject to Banking Circular 274; is that right?

Mr. LEVITT. Yes.

Mr. DINGELL. Now, what conflicts will be faced by Dreyfus in meeting both the banking and the securities laws?

Mr. LEVITT. Well, I think that the bank guidelines would have some bank regulator oversight for registered broker-dealers that assist banks in the sale of securities. That could create a redundancy and probably conflicts. I don't know where that begins or where that ends. But theoretically that is very possible.

Mr. DINGELL. They could say that they could do some things that you would say they can't; isn't that right?

Mr. LEVITT. Precisely.

Mr. DINGELL. Now, that would mean that if there is an enforcement action, which you brought against them, they would make a defense in saying that, "Our good friends at OCC," or, "Our good friends at the Fed," or, "Our good friends at the FDIC have said that we can do this." Isn't that possible?

Mr. LEVITT. I think that is possible.

Mr. DINGELL. That would constitute a defense, then, I would think, against your actions, both in civil matters, but it would clearly constitute a defense in a criminal matter; would it not?

Mr. LEVITT. Yes. Now, they also have conflicts with respect to disclosure requirements. The OCC guidelines require a prospectus disclosure of investment risks, including the possible loss of principal.

But in contrast to that, the SEC requirements are really specifically tailored for money market funds and mandate disclosure that there can be no assurance that the fund will be able to maintain a stable net asset value of $1 per share. It is a very different kind of disclosure requirement.

Mr. DINGELL. They wouldn't have to disclose that?

Mr. LEVITT. No.

Mr. DINGELL. Why not, under banking law?

Mr. LEVITT. I am told that they would not have that element to deal with.

Mr. BARBASH. I don't know that it is a question of their not disclosing it. It would be a situation where that particular language would not fit within the particular mandated disclosure that the guidelines talk about. In other words, it does not precisely say that there is a possibility of a loss of principal.

Typically, that is not a term that is used in a mutual fund context. That is a bank account type of term.

Mr. DINGELL. It sounds a little like what went on in Lincoln Savings. Just a little, not a lot. A little.

Mr. LEVITT. Another difference, I would say, is with respect to ability to supervise. This is really fundamental to the SEC's regulation of broker-dealers.

I think with respect to the bank guidelines, it is much less specific. This is a very important issue. I think that Dreyfus as part of Mellon will have banking laws, securities laws, and bank guidelines to observe. As we said before, that is going to create overlap, inefficiencies, confusion, and differences.

Mr. DINGELL. They would be burning incense at five altars. And as my old friend, Mannie Sellers, used to say, they would burn one candle for Christ, and one candle to the Devil, and take no chances in-between; isn't that right?

Now, how do you envision that the conflicts between securities laws and banking laws would be resolved? So far the Courts have been very kind to the bank regulators. They say to SEC, "You folks don't have any say in these matters."

Mr. LEVITT. There is only one way, in my judgment, and that is by legislation.

Mr. DINGELL. Well, until the Congress acts, it would, of course, be a complex, long-running series of regulatory disagreements followed by litigation, in which every party would be involved.

First of all, the bank regulators would be involved. Second of all, the banks would be involved. All four bank regulators would be involved. You folks would be involved. I guess the Department of Justice and the Solicitor General would be involved; wouldn't they?

Mr. LEVITT. I think there could be all of that. I must say that Comptroller Ludwig and I have discussed this issue at some length. We have endeavored to try to harmonize our approach to several issues that have come before us.

But I don't really think that a personal relationship, as good and as sound as it is, is a substitute for the response to the complexity and redundancy of the kinds of issues that come before us.

Mr. DINGELL. Now, consumers would be involved? Banks would be involved? Consumer lawyers would be involved? Bank lawyers would be involved? This would be a wonderful thing for the legal profession. Just imagine the billable hours that could be achieved here by the lawyers. Some of this litigation could be kept going for years.

There is a story in Gilbert and Sullivan about how litigation was kept going. There is also some in Dickens about how litigation was kept going for years. As a matter of fact, there is one about one young attorney who came into a firm. He terminated an estate that had been the livelihood of the whole firm for years. He was, of course, immediately fired, as they prudently should have done.

But we could look forward to a massive new influx of business for the Federal Courts out of this kind of situation; could we not?

Mr. LEVITT. Yes.

Mr. DINGELL. Now, Mr. Levitt, the interagency statement issued by the four bank regulators 2 weeks ago raises the same conflict problems; does it not?

Mr. LEVITT. Yes, it does.

Mr. DINGELL. Now, as I read it, the bank regulators contemplate that the compliance procedures implemented pursuant to the statement and banking regulator oversight will apply not only to employees of depository institutions but also to SEC-regulated broker-dealers; is that right?

Mr. LEVITT. That is correct.

Mr. DINGELL. The result was that from this they would be having their rules applied to people who are now under your regulation; isn't that right?

Mr. LEVITT. Yes, sir.

Mr. DINGELL. That does seem to be something of an invasion of a rather successful undertaking by you. It seems to again afford a splendid opportunity for more litigation; does it not?

Mr. LEVITT. It certainly won't make life easier for us in terms of doing our job.

Mr. DINGELL. Well, your job is to catch rascals and to keep the market honest.

Mr. LEVITT. Yes.

Mr. DINGELL. So instead of spending your time keeping the market honest, catching rascals, and protecting consumers as you are now very well doing, your job would get a new dimension. You

would be compelled then to go forth to do battle with not one, but four banking regulators.

Am I fair to observe that you would then have your regulation, either the regulations of one of the regulators or all of the regulators, or all four of the regulators?

Mr. LEVITT. I think there is clearly that risk.

Mr. DINGELL. You would have a potential for a splendid set of complexities which would literally almost know no bounds because banks are now in hundreds of mutual funds. They are now selling billions of dollars worth of securities on the market. They are receiving enormous emoluments from these activities.

Now, I am curious. Your rules require at the SEC that the dealers and other people in the securities industry function for the protection of the investors; is that right?

Mr. LEVITT. Yes.

Mr. DINGELL. Now, the rules in the banking regulators say that they protect the solvency of the bank; isn't that right?

Mr. LEVITT. And they protect the depositor in that bank.

Mr. DINGELL. And the depositors. But nowhere does it say anything about protecting the victims of wrong-doing by bank employees who are engaged in the sale of mutual funds or other securities; isn't that right?

Mr. LEVITT. It is clearly a different emphasis.

Mr. DINGELL. Now, you are not able to protect them. If you try, you are going to be engaged in a massive feud with not one but four very powerful Federal bank regulators, and hundreds of growing and enormously influential banks. Now how are you going to resolve this in the public interest to protect the consumers?

Mr. LEVITT. It creates a definite problem that we have talked about. It's not rational. It is a bizarre patchwork quilt of redundant regulation. The only response to it, I believe, is to get at this issue of functional regulation which your bill provides for.

Mr. DINGELL. Well, let's look at this now. They are going to have your regulations, which are pretty stern for the protection of investors. Then they are going to have the regulations either issued by one of four bank regulators, or by all four.

Now, let's just say for the purposes of our discussion that I am Mr. Slick. I am in charge of the trust part of the bank. My function here now is going to be pick the set of regulations which are going to be most suitable to my maximizing first, my own earnings, and second of all, the earnings of the bank, and of course, my commission at the year end.

Whose regulations am I going to pick? The hard regulations that you are going to lay out, or the wonderful friendly regulations that are going to be set in place by these goodhearted Federal bank regulators?

Mr. LEVITT. That might be considered regulatory arbitrage.

Mr. DINGELL. Well, what we are assuming then, is that we are looking at a race to the bottom; are we not?

Mr. LEVITT. I think there is every danger of that in this present——

Mr. DINGELL. And as a matter of fact, the history of the way the banks have protected investors in securities tends to indicate that there will be this highly selective and enthusiastic and very, very

prudent race for the bottom in terms of regulatory protection; does it not?

Mr. LEVITT. Yes, perhaps.

Mr. DINGELL. There is a long history of how the bank regulators have functioned.

Mr. LEVITT. Yes.

Mr. DINGELL. We seem to have a modest problem here with overlap and conflicts. I would like to address that. This will be detrimental to both the depository and securities institutions as well as detrimental to the public. The OCC advises us that the SEC and OCC have made significant progress in coordinating your respective examination and enforcement programs. Is that true?

Mr. LEVITT. We have worked cooperatively with the OCC on a number of issues. We have worked in terms of a special survey to determine the extent of investor confusion. I think we have a satisfactory working relationship between Comptroller Ludwig and myself.

Mr. DINGELL. For the record, would you submit to us a list of the dates, participants, summaries of any and all interagency meetings on this subject, and also please submit for the record copies of any memoranda of understanding between the SEC and the OCC with respect to the terms and the conditions of such joint examination and enforcement programs?

Mr. LEVITT. Yes, sir.

Mr. DINGELL. We would like to see it. We are going to ask the same question of the OCC when they are before us tomorrow.

Now, for our purposes today, would you briefly summarize to the committee your progress in this area?

Mr. LEVITT. Our progress in terms of coordination?

Mr. DINGELL. Yes.

Mr. LEVITT. I would say that we have had a number of contacts. We have worked on a number of issues, but, again, this is hardly a pattern that can be relied upon. Our personal relationship is a good and a strong one, but chairmen and comptrollers change and attitudes change, and the staff has a vested interest in protecting a pattern of doing business and ways of handling things so that I think that alone is insufficient to rely upon addressing these serious issues.

Mr. DINGELL. Could you assist us by informing me of any concrete result from this period of discussions between your Agency and the OCC?

Mr. LEVITT. I think there have been some results. We have agreed to work on a survey. We have had a number of——

Mr. DINGELL. You have agreed to work on a survey, what else?

Mr. LEVITT. We have had one enforcement issue that provided a level of conflict before Comptroller Ludwig and I discussed it.

Mr. DINGELL. What was that?

Mr. LEVITT. It was a case involving a bank, as a matter of fact.

Mr. DINGELL. A bank, what did this good-hearted bank do?

Mr. LEVITT. If you like, Mr. Chair, I can call upon my colleague Mr. McLucas to discuss the specifics of this.

Mr. DINGELL. No, just a quick summary.

Mr. LEVITT. Well, it was in connection with a failure to destroy some bonds that subsequently wound up in the hands of people who shouldn't have had those bonds.

Mr. DINGELL. I assume that the enforcement then was done under banking laws as opposed to under your laws?

Mr. LEVITT. No. We had a jurisdictional dispute on this. In 1992, both the SEC and OCC brought enforcement actions against Citibank for its failure to properly destroy cancelled security certificates and to file timely missing securities reports for up to $111 billion face value.

On June 25th of 1992, the OCC instituted a settled administrative action against Citibank finding that it violated section 17(a) and 17(f)(1) of the Exchange Act, and Rule 17(a)(D)(12) and 17(f)(1) thereunder censuring it and ordering certain remedial measures.

The OCC action lacked any requirement that Citibank comply with the provisions at issue. On December 17th of 1992, the Commission filed a settled cease and desist proceeding against Citibank ordering that Citibank permanently cease and desist from violating the above provisions. The Commission also filed a settled action for a civil money penalty in U.S. District Court obtaining a penalty of $750,000 for Citibank's failure to file timely missing securities reports.

Mr. DINGELL. What is the difference then between the enforcement actions which took place under your procedures and under the bank procedures?

Mr. LEVITT. I think clearly our procedures were far more stringent and, I think, frankly, far more appropriate.

Mr. DINGELL. Now, had the OCC gone forward in this matter, it would be fair to say that if they had brought their matter to a conclusion, the bank would have essentially been able to use the ancient doctrine of autrefois acquit, right?

Our reporter doesn't show a nod, you have to say yes.

Mr. DINGELL. So you have one case on which you have cooperation between your Agency and the OCC, is that right? Am I fair in inferring there must be some others, or am I unfair in inferring that there must be some others?

Mr. LEVITT. I think it would be fair to say that, in the few months that Comptroller Ludwig and I have been discharging our responsibilities, we have had a number of conversations about working together on matters that may divide us. There have been several of those. I am not familiar with——

Mr. DINGELL. Several discussions?

Mr. LEVITT. There have been a number of cases, I believe, that we have discussed and worked upon, but there is hardly a comprehensive all encompassing pattern of going arm-in-arm and hand-in-hand together.

Mr. DINGELL. Mr. Ludwig likes his banking business and doesn't feel that you ought to be intruding into any of those affairs; is that right?

Mr. LEVITT. Well, he hasn't used those words. He hasn't said that. We have promised one another that we would try to cooperate wherever possible.

Mr. DINGELL. Now, Mr. Levitt, I am not sure that coordination alone is the answer to our problem.

Mr. LEVITT. I agree with you, it is not.

Mr. DINGELL. Here we are talking about trying to coordinate a process which has two separate philosophies; a process which has two separate procedures, bank procedures and securities procedures; a process which has two sets of mores and customs, banking and securities. One regulator of securities and four somewhat languid regulators of banks who have their own modest differences on how the businesses proceeded.

So we are now seeking to have government impose some rational system of dealing with securities on what is a pattern of overlapping, burdensome, conflicting laws on banks and securities forums. Now we might say we are going to lock all you good-hearted folk in a closet until you work things out, but you can only work things out within the framework of law, can't you?

Mr. LEVITT. Absolutely.

Mr. DINGELL. And so, if they don't choose to proceed, or if their basic statutes don't enable them to apply the kind of suasions that they should to securities, then nothing comes of it, does it?

Mr. LEVITT. That's correct.

Mr. DINGELL. In the meantime, you, who have a relatively limited budget and enormous responsibilities, are compelled to dissipate immense amounts of time and energy, staff and financial resources in achieving this quaint result which may or may not be of merit; is that right?

Mr. LEVITT. I think that is fair.

Mr. DINGELL. Now wouldn't the country be better served if these institutions and the public could know that we have clear functional lines of responsibility, required cooperation, information sharing, necessary gathering of information, necessary regulatory actions, clear lines of behavior and responsibility on all parties concerned?

Mr. LEVITT. It would be more efficient. It would give greater investor protection. It would be more rational and sound and logical.

Mr. DINGELL. Now it is fair to observe here, and I intend to inquire of Mr. Ludwig when he comes before us tomorrow, that your responsibility is to protect the investors; is that right?

Mr. LEVITT. Yes.

Mr. DINGELL. And the bank regulators have the responsibility of protecting the financial solvency and financial integrity of the bank and the depositors; is that right?

Mr. LEVITT. Yes.

Mr. DINGELL. Is there anything that you are aware of in the banking laws that requires them also to protect investors and securities?

Mr. LEVITT. I am not aware of anything.

Mr. DINGELL. Do you think we ought to ask Mr. Ludwig about that?

Mr. LEVITT. Yes.

Mr. DINGELL. I really look forward to his answer.

Any further questions?

[No response.]

Mr. DINGELL. Mr. Levitt, Mr. Barbash, we thank you.

Do you have any comments you would like to make?

Mr. LEVITT. The only comment I have to make is, again, to encourage the process to go forward with the kind of functional regulation that I think is so logical and so necessary and yet has eluded us. The system today, from my experience in the securities industry, is rife with far more risks than ever before in history. We can ill afford the kind of confusion that exists in this regulatory never-neverland.

Mr. DINGELL. We have this enormous problem here then of coordination which you have described. We can put you and the SEC and Mr. Ludwig and the OCC and all the other good-hearted folks over there amongst the banking regulators in this room and have a tremendous battle which will go on interminably, but we have other mechanisms. We have H.R. 3447. Is there a possibility in your mind that that might solve a lot of the problems?

Mr. LEVITT. I think that would be the ideal resolution to this issue.

Mr. DINGELL. What it would do would be—it wouldn't get into the banking business at all, would it?

Mr. LEVITT. No.

Mr. DINGELL. It would just require that the banks, when they are moving out into other folks' business, play by the same rules that everybody else does.

Mr. LEVITT. It would level the playing field.

Mr. DINGELL. And it would require the bankers to perhaps protect the public interest; isn't that right?

Mr. LEVITT. Yes, sir.

Mr. DINGELL. And it would absolve poor Mr. Ludwig and all of the others of the unfortunate responsibilities of dealing with investor protection, wouldn't it?

Mr. LEVITT. Yes.

Mr. DINGELL. And give you the powers that you need to protect the poor old widow Consumer——

Mr. LEVITT. I think it would.

Mr. DINGELL [continuing]. Against Mr. Frank B. Sly and all the other slickers who would otherwise be absolved of responsibilities to protect investors, wouldn't it?

Mr. LEVITT. Yes.

Mr. DINGELL. Then we wouldn't have to worry about them going down to Brazil where we have no extradition laws.

Well, gentlemen, you have been of great assistance to the subcommittee. We thank you. We appreciate your kindness and courtesy to us.

Thank you.

The Chair announces that our next panel is Mr. Steven Zipperstein, Esquire, Chief Assistant U.S. Attorney for the Central District of California, Los Angeles, California; accompanied by Ms. Alice Hill, Esquire, Assistant U.S. Attorney for the Central District of California; also by Mr. Bill Hodgman, Esquire, Office of Los Angeles District Attorney; Mr. Len Simon, Esquire, Milberg Weiss Bershad Hynes & Lerach.

Ladies and gentlemen, we want to thank you for your assistance to us and for being here. We hope that we have not kept you overlong, but sometimes we become inspired by the questions that are before us and are not fully able to restrain in these matters,

but I want to express my personal thanks and the thanks also of the committee to each of you for your kindness and your assistance to us. We believe that you have a great deal to tell us which will be of value.

You have heard the Chair qualify the previous panel. Ladies and gentlemen, do any of you have any objection to testifying under oath?

[No response.]

Mr. DINGELL. The Chair advises that is the regular practice of the committee. It is your right to be advised by counsel. Do any of you desire to be advised by counsel during your presence here?

[No response.]

Mr. DINGELL. The Chair advises that copies of the rules of the committee, rules of the subcommittee, rules of the House are present there before you in the blue and red booklets. They are there to advise you of the rules of the committee, the practices of the committee and, of course, the limits on the powers of the committee.

If you have no objection then, if you would please rise and raise your right hand. Do you solemnly swear that the testimony you are about to give is the truth, the whole truth, and nothing but the truth so help you God.

[Witnesses sworn.]

Mr. DINGELL. Thank you very much for being with us. We will recognize you first, Mr. Zipperstein, then Ms. Hill, then Mr. Hodgman and Mr. Simon. I want you to understand that that does not reflect our attitude on the dignity of each of you. We regard you all with high respect.

So if you will proceed.

TESTIMONY OF STEVEN E. ZIPPERSTEIN, CHIEF ASSISTANT U.S. ATTORNEY, CENTRAL DISTRICT OF CALIFORNIA, ACCOMPANIED BY ALICE HILL, ASSISTANT U.S. ATTORNEY; WILLIAM W. HODGMAN, DIRECTOR, BUREAU OF CENTRAL OPERATIONS, OFFICE OF LOS ANGELES COUNTY DISTRICT ATTORNEY; AND LEONARD B. SIMON, ATTORNEY, SAN DIEGO, CALIF.

Mr. ZIPPERSTEIN. Good morning, Mr. Chairman and distinguished members of the subcommittee. My name is Steven Zipperstein and I am the Chief Assistant U.S. Attorney for the Central District of California in Los Angeles.

With me at my left is Assistant U.S. Attorney Alice Hill of my office. It is a great honor and pleasure for us to appear before you to testify about the Federal criminal investigation of Lincoln Savings and Loan Association. We are here to discuss publicly disclosed factual information from the Federal investigation and trial of Charles H. Keating, Jr., and others in connection with the failure of Lincoln. Because some matters related to the Federal investigation are covered by grand jury secrecy rules and because the convictions of Charles H. Keating, Jr., and his son are still on appeal, our ability to provide information may be somewhat circumscribed.

For approximately the past 5 years, my office has investigated and prosecuted crimes related to Lincoln. Lincoln was a federally

insured thrift with 29 branches throughout Southern California. Its parent corporation, American Continental Corporation or ACC, headed by Charles H. Keating, Jr., was based in Phoenix, Arizona.

In December 1986, ACC began to sell subordinated debentures, or bonds, through the Lincoln branch system. By February 1989, ACC had sold over $220 million in bonds to investors. In April 1989, ACC declared bankruptcy and Lincoln was placed into conservatorship. It is estimated that the failure of Lincoln will cost American taxpayers an estimated $3.4 billion, making it the largest thrift failure in U.S. history.

In the Spring of 1989, the U.S. Attorney's Office for the Central District of California in conjunction with the Federal Bureau of Investigation assembled a task force to begin investigating Charles H. Keating, Jr., and the collapse of Lincoln and ACC. The task force included other agencies that are listed in the prepared testimony which I would request be made a part of the record.

To date, the Federal criminal investigation has yielded the convictions of ten individuals, including Charles H. Keating, Jr., the former chairman of ACC, and his son, Charles H. Keating III, the former executive vice president of ACC.

The Federal criminal charges against Keating and his associates focus primarily on five separate criminal schemes. A scheme to create sham profits or ACC and Lincoln through fraudulent sales of undeveloped land and other assets; a scheme to sell ACC bonds through Lincoln's branch network, based, in part, on the sham profits; a scheme to transfer money illegally from Lincoln to ACC through an intercompany tax sharing agreement; a scheme to use Lincoln's money and property to bail ACC out of a costly contractual obligation; and a scheme to transfer money from ACC to Keating family members through sham loans from an ACC subsidiary while ACC was preparing to declare bankruptcy.

With regard to the bond scales scheme, the Federal criminal charges concentrated on the fraudulent financial statements used to sell the bonds. Those financial statement falsely inflated the profits that ACC had alleged the earned from the sale of certain real estate and other assets. Our Federal investigation did not focus on other bond sales techniques or practices that may have misled investors. I can make certain observations, however, regarding the deception inherent in the sale of ACC securities through its federally insured subsidiary, Lincoln Savings and Loan Association.

ACC began selling its subordinated debentures through Lincoln's 29 branches in December 1986. Sales of ACC bonds continued until February 1989, at which time the President of Lincoln, Ray Fidel, terminated the bond sales program.

By the conclusion of the bond sales program, ACC had sold approximately $220 million in bonds to approximately 17,000 investors throughout Southern California. The ACC bonds were junk bonds, junior to all other debt of ACC. Keating often referred to the ACC bonds sold through the Lincoln branches as "cheap money" both because the bonds carried an interest rate lower than more senior debt, and because they required no payment of underwriting fees. Indeed, Keating used proceeds from the bond sales to retire more senior debt held by institutional investors carrying a higher interest rate.

For many investors, ACC's marketing practices and techniques for the bonds appear to have caused a blurring of the distinction between Lincoln as a federally insured institution and ACC as the uninsured and issuer of the bonds. The marketing practices also apparently created a degree of confusion as to the nature of the bonds, including whether the bonds were federally insured. These marketing practices and techniques included the following, use of Lincoln facilities to market bonds.

When ACC began selling bonds in December 1986 through the Lincoln branches, it leased desk space from Lincoln for bond representative desks. These bond desks were generally located in the lobby of Lincoln branches near the new account area. The desks were similar in appearance to the other desks used to conduct Lincoln business. Posters touting the ACC bonds appeared in the windows of the Lincoln branches.

In June 1988, the California Department of Corporations expressed concerns about the possibility that bond purchasers might be confused by sales of ACC bonds in the Lincoln branches. By August 1988, ACC had moved its bond sales desks to satellite offices located near Lincoln branches. After the bond sales operations moved to the satellite offices, the volume of bond sales dropped significantly.

Hiring of Lincoln personnel, ACC hired employees to act as bond representatives in the Lincoln branches. Many of the bond representatives were recruited from the ranks of Lincoln tellers of other personnel. Although ACC generally moved the bond representatives hired from Lincoln to a branch different from that in which the employees had previously worked, bond representatives on occasion ended up working in the same branch where they had previously been a teller or other Lincoln employee.

Use of inexperienced bond sales representatives, ACC typically hired young, energetic, recent college graduates who had little or no experience in the securities industry to act as bond representatives. Although the bond representatives received some training, some of them reported that they had not read or understood the prospectus. ACC used various motivational ploys such as contests and parties to spur the young staff to increase its sales of bonds. The resulting false sense of camaraderie seems to have lessened some of the inhibitions that might have constrained selling behavior had the bond representatives worked in a more traditional bank environment.

Cross selling by Lincoln employees, during much of the bond sales program Lincoln employees cross sold ACC bonds. For example, if a teller observed that a Lincoln customer had a large account balance or a certificate of deposit coming due, the teller would suggest that the customer speak with the ACC bond representatives about purchasing an ACC bond. At the teller window so-called "tombstones" for the ACC bonds would be among the literature available to Lincoln customers.

Keating knew that cross-selling is so important to bond sales that after the President of Lincoln informed Keating that he had stopped all cross-selling on the advice of counsel, Keating asked, "Can't we cheat a little?"

Tapping of Lincoln's customer base, ACC regularly drew upon Lincoln's customer base to identify prospective bond purchasers. When a Lincoln customer entered a branch or was waiting in line at the teller window, an ACC bond representative would often approach the customer and ask if he or she had considered purchasing an ACC bond. The bond representative sometimes wore buttons and T-shirts advertising ACC.

If a customer had a certificate of deposit coming due, a letter would be sent suggesting that the customer come into the branch to discuss investment opportunities. Lincoln account statements on at least one occasion included teasers about ACC. Sometimes bond representatives telephoned Lincoln customers to try to sell ACC bonds. Lincoln customers were invited to attend investment seminars where ACC bonds were pitched.

The Lincoln branches that produced the highest volume of bond sales were typically located in areas with a high percentage of retirees. Many of the ACC bond purchasers had never purchased securities before and were obviously unsophisticated investors.

Payment of bonuses to Lincoln employees based on bond sales. To encourage bond sales branch-wide goals for the sale of bonds were frequently set. Often, if those goals were met, a bonus would be paid to all employees of the branch. Bonuses included cash, gift certificates, briefcases and clothing.

The cover page of both the prospectus and prospectus supplements stated in bold capitalized type that "the debentures being offered are the sole obligation of the company and not being offered as savings accounts or deposits and are not insured by the Federal Savings and Loan Insurance Corporation." The last page of the prospectus and the prospectus supplement contain the further disclaimer in bold type that "no dealer salesman or any other person has been authorized to give any information or to make any representation in connection with this offering other than those contained in this prospectus or prospectus supplement and, if given or made such information or representations, must not be relied upon as having been authorized by the company."

At the time of sale, all customers were to sign a purchase agreement stating that the purchaser "acknowledges receipt of the prospectus and prospectus supplement relating to the subordinated debentures " Despite these disclaimers, many purchasers were confused as to the uninsured nature of the bonds. Bond representatives told prospective customers that the bonds were "backed by the assets of Lincoln." Moreover, some of the bond representatives did not regularly volunteer that the bonds were, in fact, not insured. Some bond purchasers also may have believed the bonds were insured because the FSLIC symbol appeared on the door to the branches and the bonds were sold in the branches.

The rate of return on the bonds was lower than the rate of return that ACC was paying on more senior debt. Because the rate of return was only a few percentage points above what certificate of deposits were paying, however, some bond purchasers assumed that the bonds were relatively safe investments. Moreover, bond representative frequently assuaged the concerns of prospective purchasers by telling them that their investment would be secure, or that the bonds were safe or had little risk. Some told customers

that the bonds were as safe as a CD. On one occasion, Keating also instructed ACC personnel to give each bond representative a $1,000 bond in part so that bond representatives could answer honestly that they, themselves, owned a bond.

In summary, the manner in which ACC sold its bonds through the Lincoln branches appears to have misled many investors as to the true nature of the investment being made despite written disclosures warning that the bonds were not insured, and that oral statements regarding the bonds were not authorized, many investors confused the separate identity of the parent with that of its federally insured subsidiary and mistakenly concluded that the bonds were safe, carrying little or no risk.

Alice Hill and I welcome any questions you may have. Ms. Hill has served as one of two lead prosecutors from my office for the Lincoln Savings investigation from the past 5 years, during which time, I might add, Ms. Hill gave birth to two children. Through her tireless efforts, Mr. Keating was convicted of all 73 felony counts charged against him and sentenced to 12 years and 7 months in Federal prison. His son was convicted of all 64 felony counts charged against him, and he was sentenced to 8 years and 1 month in Federal prison.

Mr. Chairman, thank you for providing Ms. Hill and the opportunity to appear before you today.

[Testimony resumes on p. 125.]

[The prepared statement of Steven Zipperstein follows:]

Steven E. Zipperstein
Chief Assistant United States Attorney
Central District of California
March 2, 1994

Good morning, Mr. Chairman and distinguished Members of the Subcommittee. My name is Steven Zipperstein and I am the Chief Assistant United States Attorney for the Central District of California in Los Angeles. With me is Assistant United States Attorney Alice Hill of my office. It is a great honor and pleasure for us to appear before you to testify about the federal criminal investigation of Lincoln Savings and Loan Association. We are here to discuss publicly disclosed factual information from the federal investigation and trial of Charles H. Keating, Jr. and others in connection with the failure of Lincoln Savings and Loan Association ("Lincoln"). Because some matters related to the federal investigation are covered by grand jury secrecy rules and because the convictions of Charles H. Keating, Jr. and his son are still on appeal, our ability to provide information may be somewhat circumscribed.

For approximately the past five years, my office has investigated and prosecuted crimes relating to Lincoln. Lincoln was a federally insured thrift with 29 branches throughout Southern California. Its parent corporation, American Continental Corporation ("ACC"), headed by Charles H. Keating, Jr., was based in Phoenix, Arizona. In December, 1986, ACC began to sell subordinated debentures ("bonds") through the Lincoln branch system. By February, 1989, ACC had sold over $220 million

bonds to investors. In April, 1989, ACC declared bankruptcy and Lincoln was placed into conservatorship. It is estimated that the failure of Lincoln will cost American taxpayers an estimated $3.4 billion, making it the largest thrift failure in United States history.

In the spring of 1989, the United States Attorney's Office for the Central District of California, in conjunction with the Federal Bureau of Investigation, assembled a task force to begin investigating Charles H. Keating, Jr. and the collapse of Lincoln and ACC. That task force eventually grew to include representatives from the U.S. Attorney's Offices in the Central District of California and the District of Arizona, the Federal Bureau of Investigation, the Criminal Investigation Division of the Internal Revenue Service, the Orange County District Attorney, the Arizona Attorney General's Office, the Office of Thrift Supervision, the Securities and Exchange Commission and the Resolution Trust Corporation. To date the federal criminal investigation has yielded the convictions of ten individuals: Charles H. Keating, Jr., former Chairman of ACC, and his son, Charles H. Keating III, former Executive Vice-President of ACC; Judy Wischer, former President of ACC; Robert M. Wurzelbacher, a former Senior Vice-President of ACC and son-in-law of Charles Keating, Jr.; Andrew Ligget, former Chief Financial Officer of ACC and a Director of Lincoln; Bruce Dickson, a former President of Lincoln and Vice-President of ACC; Mark S. Sauter, a former attorney for ACC; Robin S. Symes, the former Chief Executive

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Officer and Chairman of the Board of Lincoln; Raymond C. Fidel, a former President of Lincoln; and Ernest C. Garcia II, a Tucson based real estate developer.

The federal criminal charges against Keating and his associates focused primarily on five separate criminal schemes: a scheme to create sham profits for ACC and Lincoln through fraudulent sales of undeveloped land and other assets; a scheme to sell ACC bonds through Lincoln's branch network based in part on the sham profits; a scheme to transfer money illegally from Lincoln to ACC through an intercompany "tax-sharing agreement"; a scheme to use Lincoln's money and property to bail ACC out of a costly contractual obligation; and a scheme to transfer money from ACC to Keating family members through sham loans from an ACC subsidiary while ACC was preparing to declare bankruptcy.

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ACC began selling its subordinated debentures through Lincoln's 29 branches in December, 1986. Sales of ACC bonds

continued until February, 1989, at which time the President of Lincoln, Ray Fidel, terminated the bond sales program. By the conclusion of the bond sales program, ACC had sold approximately $220 million in bonds to approximately 17,000 investors throughout Southern California. The ACC bonds were "junk bonds", junior to all other debt of ACC. Keating often referred to the ACC bonds sold through the Lincoln branches as "cheap money", both because the bonds carried an interest rate lower than more senior debt and because they required no payment of underwriting fees. Indeed, Keating used proceeds from the bond sales to retire more senior debt held by institutional investors carrying a higher interest rate.

For many investors, ACC's marketing practices and techniques for the bonds appear to have caused a "blurring" of the distinction between Lincoln as a federally insured institution and ACC as the uninsured issuer of the bonds. The marketing practices also apparently created a degree of confusion as to the nature of the bonds, including whether the bonds were federally insured. These marketing practices and techniques included the following:

- <u>Use of Lincoln facilities to market bonds.</u> When ACC began selling bonds in December, 1986, through the Lincoln branches, it leased desk space from Lincoln for bond representative desks. These bond desks were generally located in the lobby of Lincoln branches near the new

account area. The desks were similar in appearance to the other desks used to conduct Lincoln business. Posters touting the ACC bonds appeared in the windows of the Lincoln branches. In June, 1988, the California Department of Corporations expressed concerns about the possibility that bond purchasers might be confused by sales of ACC bonds in the Lincoln branches. By August, 1988, ACC had moved its bond sales desks to "satellite offices" located near Lincoln branches. After the bond sales operations moved to the satellite offices, the volume of bond sales dropped significantly.

- Hiring of Lincoln personnel. ACC hired employees to act as bond representatives in the Lincoln branches. Many of the bond representatives were recruited from the ranks of Lincoln tellers or other personnel. Although ACC generally moved the bond representatives hired from Lincoln to a branch different from that in which the employees had previously worked, bond representatives on occasion ended up working in the same branch where they had previously been a teller or other Lincoln employee.
- Use of inexperienced bond sales representatives. ACC typically hired young, energetic, recent college graduates who had little or no experience in the securities industry to act as bond representatives. Although the bond representatives received some training, some of them reported that they had not read or understood the

prospectus. ACC used various motivational ploys, such as contests and parties, to spur the young staff to increase its sales of bonds. The resulting false sense of camaraderie seems to have lessened some of the inhibitions that might have constrained selling behavior had the bond representatives worked in a more traditional bank environment.

- Cross-selling by Lincoln employees. During much of the bond sales program, Lincoln employees "cross-sold" ACC bonds. For example, if a teller observed that a Lincoln customer had a large account balance, or a Certificate of Deposit coming due, the teller would suggest that the customer speak with the ACC bond representatives about purchasing an ACC bond. At the teller window, "tombstones" for the ACC bonds would be among the literature available to Lincoln customers. (A sample tombstone is attached as Exhibit A). Keating viewed the "cross-selling" as so important to bond sales that, after the President of Lincoln informed Keating that he had stopped all cross-selling on the advice of counsel, Keating asked, "Can't we cheat a little?"
- Tapping of Lincoln's customer base. ACC regularly drew upon Lincoln's customer base to identify prospective bond purchasers. When a Lincoln customer entered the branch or was waiting in line at the teller window, an ACC bond representative would often approach the customer and ask if he or she had considered purchasing an ACC bond. The bond

representatives sometimes wore buttons and T-shirts advertising ACC. If a customer had a Certificate of Deposit coming due, a letter would be sent suggesting that the customer come into the branch to discuss "investment opportunities". (A sample letter is attached as Exhibit B). Lincoln account statements, on at least one occasion, included "teasers" about ACC. Sometimes bond representatives telephoned Lincoln customers to try to sell ACC bonds. Lincoln customers were invited to attend "investment seminars" where ACC bonds were pitched. (A sample letter is attached as Exhibit C). The Lincoln branches that produced the highest volume of bond sales were typically located in areas with a high percentage of retirees. Many of the ACC bond purchasers had never purchased securities before and were obviously unsophisticated investors.

- <u>Payment of bonuses to Lincoln employees based on bond sales.</u> To encourage bond sales, branch-wide goals for the sale of bonds were frequently set. Often, if those goals were met, a bonus would be paid to all employees at the branch. Bonuses included cash, gift certificates, briefcases, and clothing.
- <u>Contradictory messages about uninsured nature of the bonds.</u> The cover page of both the prospectus and prospectus supplements stated in bold capitalized type that "THE DEBENTURES BEING OFFERED ARE THE SOLE OBLIGATION OF THE

COMPANY AND ARE NOT BEING OFFERED AS SAVINGS ACCOUNTS OR DEPOSITS AND ARE NOT INSURED BY THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION." The last page of the prospectus and the prospectus supplement contained the further disclaimer in bold type that "No dealer, salesman or any other person has been authorized to give any information or to make any representation in connection with this offering other than those contained in this [Prospectus/Prospectus Supplement], and if given or made, such information or representations must not be relied upon as having been authorized by the Company." (A sample Prospectus and Prospectus Supplement is attached as Exhibit D). At the time of sale, all customers were to sign a purchase agreement stating that the purchaser "acknowledges receipt of the Prospectus and Prospectus Supplement relating to the Subordinated Debentures". (A sample Purchase Agreement is attached as Exhibit E). Despite these disclaimers, many purchasers were confused as to the uninsured nature of the bonds. Bond representatives told prospective customers that the bonds were "backed by the assets of Lincoln". Moreover, some of the bond representatives did not regularly volunteer that the bonds were, in fact, not insured. Some bond purchasers also may have believed the bonds were insured because the FSLIC symbol appeared on the door to the branches and the bonds were sold in the branches.

- <u>Failure to disclose true risk.</u> The rate of return on the bonds was lower than the rate of return that ACC was paying on more senior debt. Because the rate of return was only a few percentage points above what certificate of deposits were paying, however, some bond purchasers assumed that the bonds were relatively safe investments. Moreover, bond representatives frequently assuaged the concerns of prospective purchasers by telling them that their investment would be "secure", or that the bonds were "safe" or "had little risk". Some told customers that the bonds were "as safe as a CD." On one occasion, Keating also instructed ACC personnel to give each bond representative a $1000 bond, in part so that bond representatives could answer "honestly" that they themselves owned a bond.
- <u>Identical logos.</u> Lincoln and ACC shared an identical logo.

In summary, the manner in which ACC sold its bonds through the Lincoln branches appears to have misled many investors as to the true nature of the investment being made. Despite written disclosures warning that the bonds were not insured, and that oral statements regarding the bonds were not authorized, many investors confused the separate identity of the parent with that of its federally insured subsidiary, and mistakenly concluded that the bonds were safe, carrying little or no risk.

Alice Hill and I welcome any questions you may have. Ms. Hill has served as one of two lead prosecutors for the Lincoln Savings investigation for the past five years. Through her efforts, Mr. Keating was convicted of all 73 felony counts charged against him and sentenced to 12 years and 7 months. His son was convicted of all 64 felony counts charged against him and sentenced to 8 years and 1 month.

Thank you for providing us the opportunity to appear before you today.

EXHIBIT A

AMERICAN CONTINENTAL CORPORATION

SUBORDINATE DEBENTURES
FIRST INTEREST PAYMENT/$1000 PRINCIPAL

DAY OF MONTH PURCHASED	2 Year 10.500%	5 Year 12.000%
1	$8.75	$10.00
2	8.46	9.67
3	8.17	9.33
4	7.88	9.00
5	7.58	8.67
6	7.29	8.33
7	7.00	8.00
8	6.71	7.67
9	6.42	7.33
10	6.13	7.00
11	5.83	6.67
12	5.54	6.33
13	5.25	6.00
14	4.96	5.67
15	4.67	5.33
16	4.38	5.00
17	4.08	4.67
18	3.79	4.33
19	3.50	4.00
20	3.21	3.67
21	2.92	3.33
22	2.63	3.00
23	2.33	2.67
24	2.04	2.33
25	1.75	2.00
26	1.46	1.67
27	1.17	1.33
28	0.88	1.00
29	0.58	0.67
30	0.29	0.33
31	0.00	0.00

(Rates are subject to change for subsequent series.) 1/88

AMERICAN CONTINENTAL CORPORATION

SUBORDINATE DEBENTURES MONTHLY INTEREST PAYMENTS

PRINCIPAL	2 Year 10.500%	5 Year 12.000%
$ 2,000	$ 17.50	$ 20.00
3,000	26.25	30.00
4,000	35.00	40.00
5,000	43.75	50.00
6,000	52.50	60.00
7,000	61.25	70.00
8,000	70.00	80.00
9,000	78.75	90.00
10,000	87.50	100.00
11,000	96.25	110.00
12,000	105.00	120.00
13,000	113.75	130.00
14,000	122.50	140.00
15,000	131.25	150.00
16,000	140.00	160.00
17,000	148.75	170.00
18,000	157.50	180.00
19,000	166.25	190.00
20,000	175.00	200.00
21,000	183.75	210.00
22,000	192.50	220.00
23,000	201.25	230.00
24,000	210.00	240.00
25,000	218.75	250.00
30,000	262.50	300.00
35,000	306.25	350.00
40,000	350.00	400.00
45,000	393.75	450.00
50,000	437.50	500.00
55,000	481.25	550.00
60,000	525.00	600.00
65,000	568.75	650.00
70,000	612.50	700.00
75,000	656.25	750.00
80,000	700.00	800.00
85,000	743.75	850.00
90,000	787.50	900.00
95,000	831.25	950.00
100,000	875.00	1,000.00

(Rates are subject to change for subsequent series.) 1/88

LINCOLN SAVINGS
A Subsidiary of American Continental Corporation

EXHIBIT B

March 10, 1988

[redacted]

Account Number: [redacted] Maturity Date: 4/11/88
Renewal Maturity Date: 4/11/93 Branch Number: (714) 679-6801

Dear [redacted]:

We appreciate the opportunity you have given us to service your Investment Certificate which will mature on the date shown above. For your convenience this account will automatically renew for an additional term equal to the current term unless you give us other instructions on or before the seventh day after the maturity date. We have enclosed a statement which contains provisions which will apply to the renewal of this account. Some of these terms may have changed since you originally opened this certificate. The rate of interest upon renewal will be the rate in effect on the renewal date for other accounts of this class.

Please call your branch office to discuss current reinvestment opportunities available at Lincoln Savings or to answer any questions you may have concerning our services.

Thank you for your continued support.

R S Symes

R. S. Symes
Chairman of the Board

FSLIC

EXHIBIT c

AMERICAN
CONTINENTAL
CORPORATION
2735 East Camelback Road/Phoenix, Arizona 85016/(602) 224-7844

September 28, 1988

[redacted]

Dear [redacted]:

I am proud to announce the openings of our American Continental Financial Service offices throughout Southern California. These openings follow the successful completion of our initial $200 million American Continental Corporation (ACC) Subordinate Debenture issue sold through our Lincoln Savings branches.

These offices will be offering investments to meet your financial needs through ACC Subordinate Debentures, tax deferred annuities and other financial products.

ACC is one of America's fastest growing companies. It is a $6.5 billion diversified financial holding company, based in Phoenix, Arizona, with investments in banking, land development, retail shopping centers, hotels and insurance. Lincoln Savings, based in Irvine, California, is the largest subsidiary of ACC, with 29 branches throughout Southern California.

Our current offering of subordinate debentures features a $2,000 minimum investment, no fees or commissions and monthly interest payments. Three different series are available for you to consider:

9.50% for 1 Year
10.50% for 2 Years
12.00% for 5 Years

Our offices will be holding investment seminars during the coming months. Please feel free to call or better yet, stop in and talk with us about these investments and reserve a space in our next seminar.

Sincerely,

Judy J. Wischer

Judy J. Wischer
President

EXHIBIT D

$300,000,000
American Continental Corporation
Subordinate Debentures
(Issuable in Series)

Minimum Purchase: $1,000

American Continental Corporation (the "Company") is offering directly to the public up to $300,000,000 aggregate principal amount of its Subordinate Debentures (the "Debentures"). The Company intends to offer the Debentures for sale directly to the public from time to time pursuant to this Prospectus. Based upon market conditions, the Company periodically will establish series of Debentures which will conform to the description of the Debentures set forth in this Prospectus.

The Debentures will be offered to the public primarily through the selling efforts of full-time employees of the Company and its affiliates other than Lincoln Savings and Loan Association ("Lincoln Savings"), at each of Lincoln Savings' branches in California and at the Company's offices in Phoenix, Arizona. In addition, subject to the receipt of applicable state regulatory approvals, the Company may send notice of the offering of one or more series of Debentures, or a copy of this Prospectus and the Prospectus Supplement(s) relating to such series, to holders of other securities of the Company and its subsidiaries in the states where such holders reside. See "Plan of Distribution."

Unless otherwise stated in a Prospectus Supplement, interest on each series of Debentures will be payable on the 28th day of each calendar month, with respect to interest accrued through the last day of the preceding calendar month. Each Debenture will bear interest from the date on which payment of the purchase price is received by the Company. The Debentures will be redeemable on the dates, and at the prices, set forth in the Prospectus Supplement relating to such series.

The Debentures will be subordinated to all Senior Indebtedness (as defined) of the Company. The Indenture under which the Debentures are to be issued does not limit the amount of Senior Indebtedness the Company may incur. At December 31, 1987, the Company had outstanding approximately $150,134,000 of Senior Indebtedness. Unless otherwise stated in a Prospectus Supplement, the Debentures will be sold in minimum denominations of $1,000. See "Description of Debentures."

Because the Debentures are being offered by the Company directly to the public without a firm underwriting commitment, no assurance can be given as to the amount of Debentures that will be sold, and the Company is not required to sell any minimum aggregate principal amount of Debentures or of any series of Debentures. It is unlikely that a market for the Debentures will exist after the offering. Accordingly, it will be difficult to resell the Debentures, particularly because it is anticipated that various series will bear different interest rates and have different maturity dates. For a description of certain risks and other factors, see "Special Factors."

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

THE DEBENTURES BEING OFFERED ARE THE SOLE OBLIGATION OF THE COMPANY AND ARE NOT BEING OFFERED AS SAVINGS ACCOUNTS OR DEPOSITS AND ARE NOT INSURED BY THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION.

	Maximum Price to Public(1)	Underwriting Discount	Maximum Proceeds to Company(1)(2)
Per Debenture	100%	-0-	100%
Maximum Aggregate Offering Price(3)	$300,000,000	-0-	$300,000,000

(1) In no case shall the Maximum Price to Public of all series of Debentures exceed the amount set forth under Maximum Aggregate Offering Price.
(2) Before deducting expenses payable by the Company, estimated to be $215,000 plus $25,000 per series. See "Use of Proceeds."
(3) There is no minimum amount of Debentures required to be sold by the Company.

This Prospectus does not contain complete information with respect to each series of Debentures proposed to be sold. A Prospectus Supplement with respect to each series of Debentures offered hereunder will set forth, with regard to such series, (i) the maximum aggregate principal amount, interest rate and maturity date of the Debentures of such series and (ii) the redemption provisions with respect to such series. **Debentures of any series may not be sold and offers to buy may not be accepted unless the purchaser has received both this Prospectus and the Prospectus Supplement relating to such series.**

The date of the Prospectus is June 6, 1988.

AVAILABLE INFORMATION

The Company is subject to the informational requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and, in accordance therewith, files reports and other information with the Securities and Exchange Commission (the "Commission"). Reports, proxy statements of the Company and other information can be inspected and copied at the public reference facilities maintained by the Commission at 450 Fifth Street, N.W., Washington, D.C. 20549 and its New York Regional Office, 26 Federal Plaza, New York, New York 10007 and Chicago Regional Office, 219 South Dearborn Street, Chicago, Illinois 60604, and copies of such material can be obtained from the Public Reference Section of the Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, at prescribed rates. Such material can also be inspected at the offices of the Cincinnati Stock Exchange, Dixie Terminal Building, Fourth and Walnut Streets, Cincinnati, Ohio 45202, and the Pacific Stock Exchange, 301 Pine Street, San Francisco, California 94101 on which the Company's Common Stock is listed.

The Company has filed with the Commission a Registration Statement under the Securities Act of 1933, as amended, with respect to the Debentures offered by this Prospectus. This Prospectus does not contain all the information set forth in the Registration Statement and its exhibits. Statements contained in this Prospectus as to the contents of any contract or other document referred to are not necessarily complete and in each instance reference is made to the exhibit, each such statement being qualified in all respects by such reference.

INCORPORATION OF DOCUMENTS BY REFERENCE

The Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1987 has been filed by the Company with the Commission pursuant to Section 13(a) of the Exchange Act and is incorporated herein by reference. This Prospectus is accompanied by the Company's latest Annual Report to Shareholders, filed as an Exhibit to the registration statement of which this Prospectus is a part and the Company's latest Form 10-Q filed pursuant to Section 13(a) of the Exchange Act, and each of such Annual Report and Form 10-Q is incorporated herein by reference. Any Prospectus delivered after May 14, 1988 will be accompanied by the Company's latest Form 10-Q filed pursuant to Section 13(a) of the Exchange Act.

Copies of any or all documents incorporated by reference, other than exhibits to such documents (unless such exhibits are specifically incorporated into such documents), will be provided without charge to each person to whom a copy of this Prospectus has been delivered upon the written or oral request of such person. Requests for such copies should be made to American Continental Corporation, Attention: Secretary, 2735 East Camelback Road, Phoenix, Arizona 85016, (602) 957-7170.

PROSPECTUS SUMMARY

The following summary is qualified in its entirety by the more detailed information appearing elsewhere in this Prospectus and in the financial statements appearing in the Company's latest Annual Report to Shareholders delivered with this Prospectus.

THE COMPANY

American Continental Corporation (the "Company") is a Phoenix-based holding company which is engaged principally in two lines of business: financial services and real estate activities.

The Company's principal subsidiary is Lincoln Savings and Loan Association ("Lincoln Savings"), a California-licensed savings and loan association and member of the Federal Home Loan Bank Board system, which had assets of approximately $4.7 billion at December 31, 1987. Lincoln Savings generates deposits through a twenty-nine branch network in Southern California and through nationwide marketing of insured certificates of deposit. In addition to mortgages and mortgage-backed securities, Lincoln Savings invests principally in real estate, U.S. Government securities, corporate debt and equity securities and insurance operations.

The Company's real estate activities are concentrated in Arizona, Colorado, Georgia and Texas and include land and commercial development. Prior to its acquisition of Lincoln Savings in February 1984, the Company was engaged principally in the construction, sale and financing of residential housing. In 1985, the Company discontinued all homebuilding operations.

THE OFFERING

Securities	$300,000,000 principal amount of Subordinate Debentures, issuable in series. The Debentures will rank junior in right of payment to the Company's Senior Indebtedness (as defined in the Indenture), which was approximately $150,134,000 at December 31, 1987, and the Debentures will rank pari passu with Subordinated Indebtedness of the Company, which was approximately $92,627,000 at December 31, 1987.
Interest	The Debentures of each series will bear interest at the rate specified in the Prospectus Supplement relating to such series. Unless otherwise stated in the Prospectus Supplement, interest will be payable monthly, on the 28th day of each month, with respect to interest accrued through the last day of the preceding month.
Redemption at the Option of the Company	Debentures of each series are redeemable at the option of the Company on the dates and at the redemption prices set forth in the Prospectus Supplement relating to such series. There is no sinking fund requiring payments of principal prior to maturity.
Redemption Upon Death	Under certain circumstances, the Company will redeem up to $25,000 principal amount of Debentures of any series at par upon the death of a Debentureholder, up to a maximum of $50,000 principal amount of Debentures for all series taken together.
Trustee	The First National Bank of Cincinnati.
Use of Proceeds	For working capital and other general corporate purposes.

SELECTED FINANCIAL DATA

The following tables set forth selected financial information regarding the results of operations and financial position of the Company. This information should be read in conjunction with "Management's Discussion and Analysis of Results of Operations and Financial Condition" appearing elsewhere in this Prospectus and the Consolidated Financial Statements and the Notes thereto of the Company appearing in the Company's 1987 Annual Report to Shareholders delivered together with this Prospectus.

	Year ended December 31,				
	1987(1)	1986(1)(2)	1985(1)	1984(1)(3)	1983(1)
	(In thousands except per share data and ratios)				
Income Statement Data:					
Revenues	$ 718,285	$ 852,452	$ 647,457	$365,538	$ 64,974
Earnings (loss) from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting for income taxes	25,988	43,434	66,837	24,380	(17,424)
Earnings (loss) from continuing operations before extraordinary items and cumulative effect of a change in accounting for income taxes	13,376	30,833	53,337	19,180	(7,585)
Extraordinary gain (loss), net	2,876	(6,600)	—	—	—
Discontinued operations gain (loss), net	—	—	(10,795)	1,333	26,704
Cumulative effect of a change in accounting for income taxes	3,075	—	—	—	—
Net earnings	19,327	24,233	42,542	20,513	19,119
Per share earnings (loss) applicable to common stock					
Continuing operations before extraordinary item and cumulative effect of a change in accounting for income taxes	.39	1.36	2.35	.55	(.43)
Discontinued operations	—	—	(.54)	.07	1.52
Extraordinary item	.16	(.35)	—	—	—
Cumulative effect of a change in accounting for income taxes	.17	—	—	—	—
Total	$.72	$1.01	$1.81	$.62	$1.09
Ratio of earnings to fixed charges with savings deposit interest(4)	.94	1.01	1.13	1.04	.72
Ratio of earnings to fixed charges without savings deposit interest(4)	1.20	1.25	1.43	1.14	.72
Balance Sheet Data (at period end).					
Investment securities	$1,527,236	$1,319,133	$ 517,629	$461,718	$ —
Real estate investments	890,394	811,831	574,473	298,891	29,009
Mortgage loans receivable	1,170,197	987,827	1,007,704	924,027	484,743
Total assets	5,095,197	4,571,136	4,114,907	3,237,910	802,291
Senior debt of the Company	139,288	202,992	189,916	222,061	177,287
Senior subordinated notes, net	10,846	49,358	49,393	—	—
Subordinated debt of the Company	92,627	2,496	6,345	6,345	6,354
Consolidated long-term debt (5)	814,505	1,241,879	1,362,678	1,009,521	602,307
Shareholders' equity	136,761	128,591	121,920	132,880	123,971

(1) The Company's consolidated financial statements and notes thereto reflect discontinued operations. See Note (B) to the Consolidated Financial Statements and "Management's Discussion and Analysis of Results of Operations and Financial Condition—Discontinued Operations" for additional information.

(2) Includes the results of American Founders Life Insurance Company since acquisition on January 28, 1986. See Note (C) to the Consolidated Financial Statements.

(3) Includes the results of Lincoln Savings and Loan Association since its acquisition by the Company on February 22, 1984. See Note (C) to the Consolidated Financial Statements.

(4) The ratio of earnings to fixed charges has been computed by dividing earnings from continuing operations before income taxes and fixed charges (reduced by capitalized interest) by fixed charges. The ratios have been calculated using fixed charges with and without interest on savings deposits, as indicated. For the years ended December 31, 1987 and 1983, earnings were inadequate to cover fixed charges; the amount of the deficiencies were $24,180,000 and $17,424,000, respectively. See "Management's Discussion and Analysis of Results of Operations and Financial Condition—Liquidity and Capital Resources" for additional discussion.

(5) Includes $87,982,000, $371,091,000, $596,145,000, $615,621,000, and $422,038,000 at December 31, 1987, 1986, 1985, 1984 and 1983, respectively, of bonds outstanding which were issued by finance subsidiaries of American Continental Mortgage Company ("ACM"), a wholly-owned subsidiary of the Company, and are secured by GNMA Certificates or first mortgage loans. At December 31, 1987, 1986, 1985 and 1984, long-term debt includes $396,023,000, $436,000,000, $375,000,000 and $100,000,000, respectively, of notes issued by Lincoln Savings, secured principally by investment securities.

SPECIAL FACTORS

Investors should consider, among other things, the following risk and other factors in connection with the purchase of Debentures:

Low Interest Rate Spread and Possible Effects. Lincoln Savings had net interest income for 1987 of $16,134,000 (after capitalization of $65,030,000 in interest expense), including approximately $16,000,000 of additional interest related to loan profit participations, compared to net interest income of $518,000 (after capitalization of $60,293,000 in interest expense) for 1986. Substantially as a result of the Company's significant investments in real estate, interest bearing liabilities exceeded interest earning assets by approximately $1,086,000,000 at December 31, 1987. A positive weighted average interest rate spread of 3.07% would have been required for interest income to be equal to interest expense at December 31, 1987; the actual weighted average interest rate spread at that date was .94%, which the Company believes is significantly below the interest rate spread of more traditional thrift institutions. The Company's net interest income for 1987 was substantially less than its selling, general and administrative expenses; the Company does not expect its interest earning assets to cover its selling, general and administrative expenses or to generate its profits, but instead relies upon the gains on its sales of securities and loans and sales of its real estate. Net interest expense or low net interest income in 1988 (after interest capitalization) could result in a significant operating loss if the interest spread is not offset by gains on sales of securities and loans or gains on the sale of real estate. See "Management's Discussion and Analysis of Results of Operations and Financial Condition—Results of Operations—Financial Services" and "Business—Financial Services—Interest Rate Spreads."

Limitations on Liquidity. Substantially all of the Company's real estate activities and its financial services operations are conducted through wholly-owned subsidiaries. As a holding company, the Company relies, in part, on dividends from its subsidiaries to fund its obligations. However, holders of the Company's debt obligations, including the Debentures being issued pursuant to this Prospectus, have no right to look to the Company's subsidiaries for repayment. Absent dividends from subsidiaries, the Company relies, in large part, on payments under tax sharing agreements with, and repayments of advances to, subsidiaries, issuance of securities and borrowings for its source of cash flow. For a description of any substantial limitations on the payment of dividends to the Company, see "Management's Discussion and Analysis of Results of Operations and Financial Condition—Liquidity and Capital Resources." At December 31, 1987, the Company had $242,761,000 of debt outstanding excluding all indebtedness of subsidiaries. This debt matures as follows: 1988—$40,464,000; 1989—$11,157,000; 1990—$68,301,000; 1991—$12,744,000; 1992—$7,713,000; and after 1992—$102,382,000.

Savings Accounts—Maturities and Rates. Lincoln Savings has significantly increased its savings accounts by marketing efforts through branch offices and by marketing insured, nonwithdrawable certificate accounts through several national brokerage firms. While the cost of these certificate accounts is greater than other deposits (with a weighted average stated interest rate of 10.46% at December 31, 1987 compared with a weighted average interest rate on all savings accounts of 8.90% at that date), such accounts have extended the average maturity of the total deposit portfolio and better match the maturity structure of Lincoln Savings' investment activities. See "Business—Financial Services—Sources of Funds."

Less than Investment Grade Securities. Interest income in 1987 includes interest on $622,166,000 principal amount (at December 31, 1987) of corporate debt securities, substantially all of which were rated less than investment grade. The risk of loss upon default of these higher-yielding securities may be greater than the risk of loss upon default of mortgage loans. See "Business—Financial Services—Investment Activities—Lincoln Savings and the Company."

Gains on Sales of Securities and Loans and Real Estate. The Company's profitability in 1987 was primarily attributable to its gains on sales of securities and loans and sales of real estate. Gains on sales of securities and loans and on sales of real estate will not be comparable from period to period. Future gains on sales of securities and loans will depend, in part, on general market conditions and the relative volatility of interest rates from period to period. See "Management's Discussion and Analysis of Results of Operations and Financial Condition—Results of Operations—Financial Services." See also "Real Estate Activities," below.

Financial Services: Loan Portfolio Risks. Lincoln Savings has emphasized the origination of mortgage loans generally exceeding $1,000,000. Lincoln Savings' loans receivable at December 31, 1987 (after deductions) were approximately 23% of its total assets. Of Lincoln Savings' loans receivable at December 31, 1987 (before deductions), approximately 69% are acquisition, development

or construction loans (including commercial, residential and other properties). Virtually all loans made since the acquisition of Lincoln Savings require "balloon" payments of principal at various points up to, and including, final maturity of the loan. Acquisition, development and construction loans are subject to risks which are different from those inherent in single-family residential mortgage loans, such as possible leasing and construction delays, cost overruns, negative cash flow and difficulties in obtaining permanent financing. Compared with traditional self-amortizing single-family loans, "balloon" payment loans extend the time for significant principal repayments and require a higher percentage of principal repayments at a given point in time. The risk of loss on all loans depends upon the reasonableness of appraisals. However, the risk of loss from an inadequate appraisal for any particular loan is greater with larger loans; if inadequate appraisals are relied upon, a risk of loss exists to the extent amounts funded exceed the actual value of the underlying security. For additional information concerning Lincoln Savings' lending activities, see "Business—Financial Services—Lending Activities".

Real Estate Activities. The emphasis of the Company's real estate operations, including development activities and loan origination, has been on acquisition, construction and development of real property and commercial projects. This concentration on larger scale projects, which are located principally in Arizona, Colorado, Georgia and Texas, highlights the requirement for careful review of each individual project. For additional information concerning the Company's real estate activities, see "Business—Real Estate Activities."

Company's Activities. As a holding company, substantially all of the Company's activities are conducted through its subsidiaries. In 1987, the Company expanded its own securities investment activities in the cash and futures markets, including investments in foreign currencies, Eurodollars, commodities and domestic and foreign debt and equity securities. The Company expects that its investment activities will be significant to the Company's future results of operations and that the profitability of these trading activities may not be comparable from period to period and will be affected by general market conditions.

FHLBB Examination; SEC Investigation; Possible Acquisition. The Federal Home Loan Bank Board (the "FHLBB") completed its 1986 examination report of Lincoln Savings in April 1987. The examination report sets forth in detail the regulatory matters raised by the FHLBB during the examination. Lincoln Savings believed that the report was in error in all material respects and in June 1987 responded in writing to the issues raised in the report. In May 1988, Lincoln Savings and the FHLBB entered into an agreement to resolve all of the issues raised by the FHLBB in the report. Lincoln Savings has agreed to make reasonable and diligent efforts to raise additional regulatory capital, and for an interim period generally not to seek approval of a growth plan or to increase aggregate equity risk investments. By October 1, 1988, the Company will purchase from Lincoln Savings for cash $10,000,000 of Lincoln Savings' preferred stock. The Securities and Exchange Commission has issued a formal order of investigation to the Company, requesting information relating principally to issues raised in the FHLBB 1986 examination report. See "Business—Regulation—Federal Home Loan Bank—FHLBB Examination" and "Management's Discussion and Analysis of Results of Operations and Financial Conditon—Liquidity and Capital Resources."

In connection with its May 1988 agreement with the FHLBB, Lincoln Savings expects to acquire another savings and loan institution in a FHLB District other than San Francisco. Lincoln Savings has not identified any particular institution for acquisition, nor does Lincoln Savings know the size or structure of the acquisition, if any. See "Business—Regulation—Federal Home Loan Bank—FHLBB Examination."

No Underwriter. Since the offering will not be underwritten, the purchasers will not have the benefit of any independent investigation of the Company of the type customarily performed by underwriters.

Limited Market. Because the Debentures are being offered by the Company directly to the public without a firm underwriting commitment, no assurance can be given as to the amount of Debentures, or of any series of Debentures, that will be sold, and the Company is not required to sell any minimum aggregate amount of Debentures or of any series of Debentures. It is unlikely that a market for the Debentures will exist after the offering and any secondary market which might develop will be very limited. The Debentures will not be listed on any securities exchange. Accordingly, it will be difficult to resell the Debentures, particularly because it is anticipated that various series will bear different interest rates and have different maturity dates and Holders cannot expect the Company to repurchase the Debentures.

THE COMPANY

American Continental Corporation (the "Company") is a Phoenix-based holding company which is principally engaged in financial services and real estate activities.

The Company provides financial services through its principal subsidiary, Lincoln Savings and Loan Association ("Lincoln Savings"), a California-licensed savings and loan association and member of the Federal Home Loan Bank ("FHLB") system which had assets of approximately $4.7 billion at December 31, 1987. Lincoln Savings was acquired by the Company on February 22, 1984 for approximately $51,000,000. Following the acquisition, the Company installed a new management team and began a program to alter substantially the lending and investment policies of Lincoln Savings. Lincoln Savings generates short- and long-term saving deposits through twenty-nine branch offices in Southern California and through nationwide marketing of insured certificates of deposit. These deposits, together with proceeds of various Lincoln Savings financings, have been invested in mortgages and mortgage-backed securities, direct investments in real estate, the origination of real estate acquisition, development and construction loans and commercial loans, corporate debt and equity securities and insurance operations. At December 31, 1987, Lincoln Savings represented 93% and 90% of the Company's consolidated assets and revenues, respectively. See "Business—Financial Services—Lincoln Savings and Loan Association—Summary Financial Information."

The Company's real estate activities are concentrated in Arizona, Colorado, Georgia, and Texas. These activities, which are conducted both by the Company and by Lincoln Savings and its subsidiaries, include land development projects involving land acquisition and the design, annexation, zoning and development of mixed-use planned communities, and the syndication, sale and management of commercial and income-producing properties.

Prior to its acquisition of Lincoln Savings, the Company was engaged principally in the construction, sale and financing of residential housing. In the second quarter of 1985, the Company sold its Phoenix homebuilding operations and commenced a program to phase out its remaining homebuilding operations. The Company's financial statements for 1985 reflect homebuilding as discontinued operations.

The Company was incorporated in 1974 under the laws of the State of Ohio. The principal executive offices of the Company are located at 2735 East Camelback Road, Phoenix, Arizona 85016 and its telephone number is (602) 957-7170. Unless the context otherwise requires, the term "the Company" as used herein refers to American Continental Corporation and its subsidiaries and the term "Lincoln Savings" refers to Lincoln Savings and Loan Association, its subsidiaries and its parent holding company, First Lincoln Financial Corporation ("First Lincoln").

USE OF PROCEEDS

The Debentures are being sold on a "best efforts" basis without a firm underwriting commitment. No assurance can be given as to the amount of Debentures that will be sold. Assuming all of the Debentures offered hereby are sold, the net proceeds available to the Company, after deduction of estimated expenses of the offering, will be approximately $299,785,000 (less approximately $25,000 in expenses for each series). The Company used the net proceeds from prior sales of Debentures for working capital purposes and to reduce outstanding indebtedness. The Company expects to use the net proceeds from continuing sales of Debentures for working capital and other general corporate purposes, including its investment activities, and to reduce outstanding indebtedness of the Company, including all or a portion of the Company's $31,050,000 principal amount of 10¼% Senior Notes due 1990 and all or a portion of the Company's $7,818,000 principal amount of 14¼% Senior Subordinated Notes due 1995. A portion of the proceeds may be used initially to reduce short-term indebtedness of the Company, which indebtedness is used for working capital purposes.

CAPITALIZATION

The following table sets forth the consolidated capitalization of the Company at December 31, 1987.

Parent	**(Dollars in thousands)**
Secured senior indebtedness of the Company (including current maturities of approximately $7,638)(1)	$ 36,373
Other senior indebtedness of the Company, net (including current maturities of approximately $10,000)	113,761
Subordinated indebtedness of the Company	92,627
Consolidated Subsidiaries	
Indebtedness of the Company's consolidated subsidiaries (including current maturities of approximately $347,031)(2)(3)	936,413
Total indebtedness(2)(3)(4)	1,179,174
Shareholders' equity	
Preferred stock, $1 par value; 19,998,000 shares authorized:	
Exchangeable preferred stock, 1,607,620 shares issued	40,191
Cumulative convertible preferred stock: 147,519 shares issued	14,752
Common stock, $.01 par value: 35,000,000 shares authorized, 17,549,859 shares issued	176
Capital in excess of par value	11,261
Marketable equity securities reserve	(21,264)
Retained earnings	109,924
Deferred compensation(1)	(17,000)
Less treasury stock (278,200 shares of common stock)	(1,279)
Total shareholders' equity	136,761
Total capitalization(4)	$1,315,935

(1) Includes $17,000,000 principal amount of Floating Rate Employee Stock Ownership Plan Notes, guaranteed by the Company. $17,000,000 of deferred compensation has been recorded as a reduction of shareholders' equity. See Note (Q) to the Company's Consolidated Financial Statements.

(2) Includes $87,982,000 of bonds issued by ACM's finance subsidiaries, secured by GNMA Certificates and first mortgage loans.

(3) Includes $396,023,000 of notes issued by Lincoln Savings and its subsidiaries, secured principally by investment securities.

(4) See Notes (K) and (L) to the Company's Consolidated Financial Statements for information concerning short-term and long-term debt of the Company and its subsidiaries at December 31, 1987.

AMERICAN CONTINENTAL CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

American Continental Corporation (the "Company") is a holding company which is engaged principally in two lines of business: financial services and real estate activities.

The Company's principal subsidiary is Lincoln Savings, which it acquired on February 22, 1984. The Company installed a new management team and substantially altered the lending, investment and other operating policies of Lincoln Savings in order to enable Lincoln Savings to receive higher yields on its assets, diversify its asset portfolio, and match more closely the interest rates and maturities of its interest-bearing liabilities. Lincoln Savings was able to significantly increase its savings accounts by more active marketing through its branch offices and by marketing insured, non-withdrawable certificate accounts through several national brokerage firms. Lincoln Savings invested the funds provided by these additional deposits principally in mortgages and mortgage-backed securities, real estate, corporate debt and equity securities and insurance operations. Prior to its acquisition by the Company, Lincoln Savings' primary lending activity consisted of long-term single-family home mortgage loans in California. Subsequently, Lincoln Savings has emphasized the origination of mortgage loans generally exceeding $1,000,000 secured by real estate located principally in Arizona, Colorado, Georgia and Texas and the origination of loans for the construction of single-family and multi-family residential property in southern California. See "Business—Financial Services—Lending Activities." The effects of these new lending, investment and operating policies have significantly affected Lincoln Savings' results of operations.

Acquisition of Lincoln Savings

The Company acquired Lincoln Savings for approximately $51,000,000. The acquisition was accounted for under the purchase method and, accordingly, all assets and liabilities acquired were adjusted to estimated fair market values as of the date of acquisition. The original excess of cost over net assets acquired (goodwill) resulting from the adjustments to market was $124,500,000. The remaining goodwill is being amortized as follows: $69,834,000 over 6-21 years using the straight-line method and $20,164,000 over the estimated remaining lives of the long-term interest bearing assets acquired using the interest method.

Discontinued Operations

In the second quarter of 1985, the Company sold its homebuilding operations in Phoenix and decided to discontinue its remaining homebuilding operations. The Company's results of operations for 1985 reflect homebuilding as discontinued operations. The discontinuation of homebuilding operations has adversely affected operations of American Continental Mortgage Company ("ACM"), the Company's mortgage-banking subsidiary.

RESULTS OF OPERATIONS

The following table summarizes the Company's results of operations and identifiable assets for the periods indicated.

	Year ended December 31,		
	1987	1986(1)	1985
		(In thousands)	
Financial Services:			
Identifiable assets	$4,073,781	$3,457,616	$3,363,556
Interest and fees on savings association loans and mortgage-backed securities	$ 162,275	$ 134,450	$ 160,872
Interest and dividends on investment securities	135,937	134,906	74,231
Gains on sale of securities and loans	102,663	73,477	116,681
Interest and fees from mortgage banking subsidiary	29,604	87,873	102,616
Insurance premiums	33,174	56,203	—
Distributions from unconsolidated affiliates	1,243	55,952	3,448
Other income allocated to financial services	16,429	8,291	6,870
Total revenues from financial services	481,325	551,152	464,718
Interest expense, savings association	256,814	256,139	231,964
Interest expense, mortgage banking operation	29,703	74,651	90,499
Current and future insurance benefits	35,657	58,720	—
Total gross profit from financial services	159,151	161,642	142,255
SG&A allocated to financial services	126,034	106,729	74,579
Provision for losses	10,718	24,221	12,648
Earnings before income taxes from financial services	22,399	30,692	55,028
Real Estate:			
Identifiable assets	$1,021,416	$1,113,520	$ 751,351
Revenues from real estate sales	$ 220,924	$ 296,039	$ 179,216
Cost of real estate sales	139,364	216,157	129,575
Gross profit from real estate sales	81,560	79,882	49,641
SG&A and interest allocated to real estate	84,189	64,126	41,355
Provision for losses	9,818	8,275	—
Other income allocated to real estate	16,036	5,261	3,523
Earnings before income taxes from real estate operations	3,589	12,742	11,809
Consolidated:			
Earnings before income taxes, extraordinary item and cumulative effect of a change in accounting for income taxes	25,988	43,434	66,837
Taxes on earnings	12,612	12,601	13,500
Earnings from continuing operations before extraordinary item and cumulative effect of a change in accounting for income taxes	13,376	30,833	53,337
Extraordinary gain (loss)—extinguishment of debt	2,876	(6,600)	—
Cumulative effect of a change in accounting for income taxes	3,075	—	—
Earnings from continuing operations	$ 19,327	$ 24,233	$ 53,337

(1) American Founders Life Insurance Company ("AFL") was acquired on January 28, 1986. Accordingly, all 1986 financial information with respect to AFL is for the period from the date of acquisition.

Corporate assets and selling, general and administrative expenses in 1987, 1986 and 1985 were allocated to financial services and real estate activities in proportion to total assets attributable to each segment.

FINANCIAL SERVICES

Revenues from interest and fees on savings association loans and mortgage-backed securities, interest and dividends on investment securities and gains on sale of securities and loans accounted for $400,875,000, or 56%, of 1987 total revenues compared to $342,833,000, or 40%, of 1986 total revenues and 54% of 1985 total revenues. Substantially all of such revenues were generated by Lincoln Savings. Approximately 40% of interest and dividend income was derived from corporate bond investments in 1987. At December 31, 1987, 1986 and 1985, respectively, Lincoln Savings and its subsidiaries owned $622,166,000, $370,861,000 and $233,256,000 principal amount of corporate debt securities, substantially all of which were rated less than investment grade, with a weighted average yield of 12.20%, 11.72% and 12.37%, respectively, and a weighted average maturity of 8.9 years, 10.3 years and 9.9 years, respectively. Lincoln Savings believes that its investment policies, including credit analyses and diversification of its portfolio, limit the risk on such investments. At December 31, 1987, Lincoln Savings' and its subsidiaries' maximum investment in the debt securities of any issuer and in any industry was $50,000,000 and $85,173,000, respectively.

Lincoln Savings had net interest income for 1987 of $16,134,000 (after capitalization of $65,030,000 in interest expense), including approximately $14,000,000 of additional interest related to loan profit participations, compared to net interest income of $518,000 (after capitalization of $60,293,000 in interest expense) for 1986 and $3,139,000 (after capitalization of $25,764,000 in interest expense) for 1985. The increase in capitalized interest over the period reflects an increase in Lincoln Savings' real estate investments and real estate development activities. As a result of the $1,086,000,000 differential between interest bearing liabilities and interest earning assets at December 31, 1987 and the interest rate spread at that date of .94%, Lincoln Savings may incur low net interest income or net interest expense (after interest capitalization) for fiscal year 1988; a positive weighted average interest rate spread of 3.07% would have been required for annualized interest income to be equal to annualized interest expense at December 31, 1987.

Gains from sales of securities and loans were $102,663,000 in 1987, $73,477,000 in 1986 and $116,681,000 in 1985. 1987 gains included approximately $35,700,000 from U.S. Treasury and government agency bonds and interest rate futures, $8,300,000 from marketable debt securities, $2,300,000 from marketable equity securities and stock index futures, $11,300,000 from foreign currencies, $8,000,000 from commodities and $37,000,000 from the sale of 50 percent of the Company's interest in the limited partnership which owns certain assets acquired in the Crown Zellerbach Corporation reorganization. 1986 gains included approximately $43,700,000 from U.S. Treasury and government agency bonds, $15,000,000 from marketable debt securities and $7,500,000 from marketable equity securities. 1985 gains from loan sales were $22,513,000, substantially all of which resulted from the sale of discounted loans acquired upon the acquisition of Lincoln Savings. These sales of discounted loans generated income tax benefits due to permanent differences between the financial reporting and tax bases of the loans. See Note (O) to the Company's Consolidated Financial Statements. The values of interest-rate sensitive assets, such as GNMA Certificates, government agency bonds and corporate debt securities, are dependent in large part on prevailing interest rates. As interest rates increase, the market value of an existing portfolio decreases; as interest rates decrease, such market value increases. As a result of these rate fluctuations, gains recognized from the sale of securities and loans will not be comparable from period to period; such gains will vary, in part, based on the relative volatility of interest rates from period to period and the Company's actual investment portfolio at the time in question. The impact of increasing interest rates on the Company's marketable equity securities portfolio is unpredictable.

Lincoln Savings recognized $55,952,000 in cash distributions in 1986 resulting from the liquidation of certain partnership assets accounted for as "Investments in Unconsolidated Affiliates", including $30,600,000 from the partnership which owns certain assets acquired in the reorganization of Crown Zellerbach Corporation and $25,252,000 from a partnership which invested in common stock of Goodyear Tire and Rubber Company.

Insurance premium revenue decreased in 1987 due to a planned reduction of the Company's annuity line of business. Interest and fees from mortgage banking operations decreased in 1987 and 1986 due to sales of GNMA certificates to retire higher cost mortgage-backed bonds.

Selling, general and administrative expenses ("SG&A") allocated to financial services increased to $126,034,000 in 1987 from $106,729,000 in 1986 and $74,579,000 in 1985, and includes $93,850,000 $82,435,000 and $52,835,000, respectively, attributable to Lincoln Savings. The increases are attributable to costs related to the growth in Lincoln Savings' deposit base and continued expansion of Lincoln Savings' land development and lending operations. In addition, the 1987 and 1986 increases are due in part to the acquisition of American Founders Life Insurance Company in January 1986 and its inclusion in 1987 and 1986 results, costs associated with the FHLBB 1986 examination of Lincoln Savings and the write-off of Lincoln Savings' $4,400,000 FSLIC secondary reserves in 1987.

Lincoln Savings' provision for possible loan or investment security losses totaled $10,718,000 in 1987, $24,221,000 in 1986 and $12,648,000 in 1985. Lincoln Savings' 1987 provision for losses included $5,669,000 in general loan loss reserves, $2,600,000 in general reserves on investments and $2,449,000 in reserves for uncollectible interest on loans and investments. These loss reserves were attributable to management's belief that larger loss reserves were prudent in light of larger average loans.

As a result of the foregoing, earnings before income taxes from financial services were $22,399,000 in 1987 compared to $30,692,000 in 1986 and $55,028,000 in 1985.

The net effect of the accretion and amortization of all purchase accounting adjustments was to decrease net income by approximately $7,800,000, $1,500,000 and $5,300,000 in 1987, 1986 and 1985, respectively. Such adjustments for the next five years will result in estimated annual reductions in consolidated net income of approximately $8,000,000.

REAL ESTATE

Revenues and gross profits from real estate sales were $220,924,000 and $81,560,000, respectively, in 1987, $296,039,000 and $79,882,000, respectively, in 1986 and $179,216,000 and $49,641,000, respectively, in 1985. The 1986 increase over 1985 reflects increased development and sales of the Company's master-planned communities and includes the sale of three Arizona properties for revenues of approximately $107,000,000.

Other income from real estate operations includes the sale of a 45% interest in the Crescent Hotel of Phoenix and The Phoenician Resort. Gross proceeds from that sale totaled $173,650,000, including $74,486,000 placed in escrow for development of The Phoenician Resort. The Company has recognized $12,880,000 gross profit on the sale: $1,570,000 of the profit is deferred and will be recognized as The Phoenician Resort is completed.

Interest expense allocated to real estate was $56,221,000 in 1987 compared to $44,709,000 in 1986 and $22,550,000 in 1985, due to the Company's increase in debt to finance its higher land inventory; all interest expense incurred by the Company, excluding Lincoln Savings and ACM, is allocated to real estate operations. Interest incurred to carry land is expensed by the Company until qualifying development activities are in process. Interest related to properties under development is generally capitalized during the development period.

SG&A allocated to real estate operations was $27,968,000 in 1987 compared to $19,417,000 in 1986 and $18,805,000 in 1985. These increases were attributable to the expansion of Lincoln Savings' land development and, in 1987 and 1986, its hotel operations.

Lincoln Savings' provision for possible real estate losses totalled $9,818,000 in 1987 and $8,275,000 in 1986. These loss reserves were attributable to larger average real estate investments and a decline in the value of certain real estate properties.

As a result of the foregoing, earnings before income taxes from real estate operations were $3,589,000 in 1987, $12,742,000 in 1986 and $11,809,000 in 1985.

CONSOLIDATED

The Company's effective federal income tax rate on continuing operations before extraordinary item was 49% in 1987, 29% in 1986 and 20% in 1985. During 1987, the Company adopted Statement of Financial Accounting Standards No. 96 (SFAS 96) "Accounting for Income Taxes". SFAS 96 requires the recomputation of the Company's deferred tax liability to reflect the legislated reduction in the federal income tax rate and its effect on the Company's ultimate tax liability. As a result, the Company adjusted its deferred tax liability and consequently increased its earnings by $3,075,000. In addition, the current year tax expense was reduced by $1,975,000 due to the fact that the Company's tax net operating loss carryforwards defer the payment of the current year expense into future years where the tax rate is lower. The Company's 1987 tax provision was above the statutory rate due to the effect of purchase accounting adjustments. The 1986 tax provision was below the statutory rate due to capital gains transactions and differences in the tax and financial reporting bases of assets sold. The 1985 tax provision was substantially below the statutory rate due to differences in the tax and financial reporting bases of assets sold.

As a result of all of the foregoing, the Company's earnings from continuing operations before a $3,075,000 cumulative effect of a change in accounting for income taxes in 1987, a $2,876,000 extraordinary gain on early extinguishment of debt in 1987 and a $6,600,000 extraordinary loss on early extinguishment of debt in 1986 were $13,376,000 in 1987 compared to $30,833,000 in 1986 and $53,337,000 in 1985.

LIQUIDITY AND CAPITAL RESOURCES

To meet its needs, the Company generates cash from savings deposits, borrowings and earnings. Earnings from continuing operations before extraordinary item and cumulative effect of a change in accounting for income taxes were $13,376,000 in 1987, $30,833,000 in 1986 and $53,337,000 in 1985. Net non-cash charges increased funds from continuing operations during the three years ended December 31, 1987 to $116,446,000 in 1987, $108,984,000 in 1986 and $176,429,000 in 1985. The Company's ratio of earnings to fixed charges was .94 for the year ended December 31, 1987. The Company's ratio of earnings to fixed charges, calculated to include all net non-cash charges to income, would have been 1.18 for the year ended December 31, 1987.

During 1987, the Company issued $90,131,000 principal amount of Debentures under a $200 million shelf registration, with an effective rate of 10.28%, and $14,752,000 of 10% Convertible Preferred Stock and retired approximately $95,000,000 principal amount of 10.75% and 14.75% public debt which had an effective rate higher than the Debentures and the Convertible Preferred Stock.

During 1986, the Company issued $50,000,000 principal amount of 12% Debentures due 2001 and retired approximately $49,000,000 principal amount of higher rate public debt.

As a result of the acquisition of Lincoln Savings, the Company's issuance of debt is subject to FHLBB approval. Approval is generally sought by filing an annual budget in November for debt to be issued during the following fiscal year; the budget submitted to the FHLBB for approval describes the general purposes for the debt expected to be issued (for instance, working capital, real estate acquisitions or refinancing) and the maximum amount of debt to be issued during that year. The Company's 1988 debt budget has been approved by the FHLBB.

Because of differences in the timing of certain revenue and expense items for tax and financial statement purposes, the Company had net operating loss carryforwards for tax purposes at the end of 1987 of approximately $110,000,000 which expire from 1992 through 2000. Such difference between the carryforwards for tax and financial statement purposes is principally due to the use, for tax purposes, of the installment sale treatment on certain sales, the expensing of interest on construction projects, and the cash basis of accounting used by Lincoln Savings. The Company has utilized all its net operating loss carryforwards available for financial statement purposes. In 1987, the Company was subject to the corporate alternative minimum tax (AMT) as revised by the Tax Reform Act of 1986, and incurred a $3,000,000 federal income tax liability. Payments of AMT can be carried forward and credited against the Company's future regular tax liability.

Lincoln Savings' principal sources of liquidity are earnings, customer deposits, Federal Home Loan Bank ("FHLB") system advances, other borrowings, repurchase agreements and principal and interest payments on loans. Lincoln Savings is required, as a member of the FHLB system, to maintain cash and eligible investments at least equal to 5% of net withdrawable deposits and short-term borrowings payable in one year or less. Deficiencies in such levels result in the assessment of fines. Lincoln Savings' management believes that Lincoln Savings met this requirement throughout 1987. See "Business—Financial Services "and" —Regulation—Federal Home Loan Bank."

To extend the average maturity of its deposits, Lincoln Savings has marketed nonwithdrawable certificate accounts through several national brokerage firms. Such certificate accounts represented 55% of total certificate accounts and had a weighted average stated interest rate of 10.46% at December 31, 1987. The majority of these certificates have remaining maturities of up to 11 years. While the cost of these certificate accounts is greater than other deposits, such accounts have extended the maturity of the total deposit portfolio and better match the maturity structure of Lincoln Savings' investment activities; at December 31, 1987, 44% of Lincoln Savings' deposits had maturities greater than one year, compared to 11% at the date of acquisition.

In addition to the traditional funds sources, Lincoln Savings issued $100,000,000 and $275,000,000 of United States dollar-denominated Collateralized Floating Rate Notes in the European markets in 1986 and 1985, respectively, and in 1987 issued in a Euroyen offering ¥7,000,000,000 (approximately $48,231,000) principal amount of Collateralized Fixed Rate Notes, collateralized primarily by cash. Lincoln Savings retired approximately $28,000,000 of the Euroyen issue in 1987.

Substantially all of the Company's real estate activities and its financial services operations are conducted through subsidiaries. As a holding company, the Company relies, in part, on dividends from its subsidiaries to fund its operations and obligations. Absent such dividends, the Company relies, in large part, on payments under tax sharing agreements with, and repayments of advances to, its subsidiaries, issuance of securities and borrowings as the source of its cash flow.

The Company depends in part upon dividends from its subsidiaries to fund its obligations. In approving the Company's application to become a savings and loan holding company, the FHLBB imposed the condition that, without prior written approval from the FHLBB, dividends paid by Lincoln Savings in any fiscal year shall be limited to 50% of net income for that fiscal year, except that any dividends permitted under this limitation may be deferred and paid in a subsequent year, subject to the provision that in no event may dividends be paid which, in fact or in the opinion of the FHLBB, would cause Lincoln Savings to fail to meet its net worth requirements. Until the earlier of the completion of its next periodic examination and resolution of any issues raised thereby or December 20, 1988, Lincoln Savings has agreed with the FHLBB that Lincoln Savings will not pay any dividends unless it notifies the FHLBB at least two weeks prior to the proposed payment and the FHLBB does not object. At December 31, 1987, approximately $65,000,000 of Lincoln Savings' retained earnings were available for the payment of dividends.

BUSINESS

The Company is a holding company engaged principally in financial services and real estate activities. Prior to its acquisition of Lincoln Savings in February 1984, the Company was engaged principally in the construction, sale and financing of residential housing. In 1985, the Company discontinued its homebuilding operations.

FINANCIAL SERVICES

The Company's financial services activities consist principally of the savings and loan and insurance operations of Lincoln Savings and the Company's investment activities. During 1987, financial service operations contributed $481,325,000 in revenues and $22,399,000 of pre-tax income, representing 67% of revenues and 86% of pre-tax income of the Company. Substantially all of the financial services operations are conducted through Lincoln Savings, with a small portion attributable to the Company and its mortgage-banking subsidiary.

Lincoln Savings and Loan Association—Summary Financial Information

Lincoln Savings emphasizes investments in mortgage-backed securities, origination of real estate and commercial loans with principal amounts generally exceeding $1,000,000, the acquisition of unimproved real estate for development and sale (see "Business—Real Estate Activities"), the purchase of corporate debt and equity securities for investment and insurance operations.

The following is a summary of certain financial information of Lincoln Savings:

	Year Ended December 31,		
	1987	1986	1985
		(In thousands)	
Summary of Operations:			
Interest income	$292,113	$269,356	$235,103
Interest expense	275,979	268,838	231,964
Net interest income	16,134	518	3,139
Net gains on sale of investment securities, loans and mortgage-backed certificates and distributions from unconsolidated affiliates	89,657	131,407	120,129
Other income, net(1)	92,569	79,689	55,977
General, administrative and other expenses	135,210	129,925	78,895
Earnings before income taxes and cumulative effect of a change in accounting for income taxes	63,150	81,689	100,350
Income taxes	25,205	32,731	20,500
Earnings before cumulative effect of a change in accounting for income taxes	37,945	48,958	79,850
Cumulative effect of a change in accounting for income taxes	3,075	—	—
Net earnings	$ 41,020	$ 48,958	$ 79,850

	As of December 31,		
	1987	1986	1985
		(In thousands)	
Summary of financial condition:			
Cash and cash equivalents	$ 242,612	$ 358,681	$ 843,607
Investment securities-equity	157,699	96,249	90,879
Investment securities-debt	1,298,190	1,193,453	426,750
Loans receivable and mortgage-backed securities(2)	1,585,820	902,021	929,519
Real estate	827,272	777,165	553,696
Other assets(3)	530,622	466,974	258,653
Excess of cost over net assets acquired	106,252	109,184	108,654
Total assets	$4,748,467	$3,903,727	$3,211,758
Savings deposits	$3,374,531	$2,821,375	$2,406,958
Borrowings	813,784	629,890	570,173
Other liabilities	338,775	259,438	89,047
Stockholder's equity	221,377	193,024	145,580
Total liabilities and stockholder's equity	$4,748,467	$3,903,727	$3,211,758

(1) "Other income" includes real estate gains of $78,708,000, $73,924,000 and $47,567,000 for the periods ended December 31, 1987, 1986, and 1985, respectively. See "Business—Real Estate Activities."

(2) "Loans receivable and mortgage-backed securities" include mortgage-backed securities of $472,461,000, $67,135,000 and $58,364,000 for the years ended December 31, 1987, 1986 and 1985, respectively.

(3) "Other assets" include $60,525,000 in 1987, $69,996,000 in 1986 and $105,895,000 in 1985 of investments in unconsolidated affiliates, representing the Company's interests in certain companies accounted for under the cost and equity methods. See Note (A) to the Consolidated Financial Statements.

Interest Rate Spreads

Historically, a significant portion of a savings and loan association's earnings was generated from its net interest income. Net interest income is affected by (i) the difference ("interest rate spread") between yields earned on its interest earning assets and rates paid on its interest bearing liabilities and (ii) the relative amounts of its interest earning assets and interest bearing liabilities. When interest earning assets exceed interest bearing liabilities, any positive interest rate spread will generate net interest income. When interest earning assets are less than interest bearing liabilities, a savings and loan association may incur a net interest expense even when the interest rate spread is positive. For the year ended December 31, 1987, Lincoln Savings had net interest income (after capitalization of $65,030,000 in interest expense) of $16,134,000, including $14,000,000 of additional interest related to loan profit participations.

The following table sets forth the average balances outstanding of all assets and liabilities of Lincoln Savings, and their respective amounts and rates of earning (or cost) during the years presented.

	1987			1986			1985		
	Average Balance	Income or Expense	Rate	Average Balance	Income or Expense	Rate	Average Balance	Income or Expense	Rate
				(Dollars in thousands)					
Assets:									
Earning assets:									
Loans receivable	$1,332,551	$162,275	12.18%	$1,008,169	$134,450	13.34%	$1,070,025	$160,872	15.03%
U.S. Government securities	452,015	31,489	6.97	496,801	35,822	7.21	185,475	17,241	9.30
Other investment securities	470,696	59,485	12.64	387,804	52,178	13.45	195,444	30,346	15.53
Other interest earning assets	601,518	38,864	6.46	700,858	46,906	6.69	301,949	26,644	8.82
Total earning assets	2,856,780	292,113	10.23	2,593,632	269,356	10.39	1,752,893	235,103	13.41
Non-earning assets(1)	1,471,691			1,237,432			887,861		
Total assets	$4,328,471			$3,831,064			$2,640,754		
Liabilities:									
Interest bearing liabilities:									
Deposits	$2,999,502	$275,344	9.18%	$2,638,407	$259,118	9.82%	$2,106,241	$223,056	10.59%
FHLB advances	43,858	5,249	11.97	48,412	5,994	12.38	56,488	6,874	12.17
Other borrowings	737,040	60,416	8.20	767,304	64,019	8.34	297,204	27,798	9.35
Total interest bearing liabilities	3,780,400	341,009	9.02	3,454,123	329,131	9.53	2,459,933	257,728	10.47
Non-interest bearing liabilities	332,606			208,616			73,919		
Total liabilities	4,113,006			3,662,739			2,533,852		
Shareholder's equity	215,465			168,325			106,902		
Total liabilities and shareholder's equity	$4,328,471			$3,831,064			$2,640,754		
Gross interest cost		(48,896)			(59,775)			(22,625)	
Less: Amount capitalized to real estate		65,030			60,293			25,764	
Net interest earnings		$ 16,134			$ 518			$ 3,139	
Gross interest spread			1.21%			.86%			2.94%
Net interest spread			.56%			.02%			.18%

(1) Non-earning assets include $865,700,000 of real estate; Lincoln Savings capitalized $65,030,000 of interest expense in 1987.

Interest income includes origination and commitment fees on loans and dividend income on investments. Non-accrual loans are included in the above table with a 0% interest rate. See "—Loan Loss Reserves."

In connection with the foregoing table, the following schedule analyzes the change in "Gross interest cost". For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to (1) changes in volume (change in volume multiplied by rate for prior year); (2) changes in rate (change in rate multiplied by volume for prior year); (3) changes in rate/volume (change in rate multiplied by change in volume). For purposes of this table, the changes in rate/volume have been allocated to the change in volume and the change in rate in proportion to the dollar amounts of the changes in each.

	1987 vs 1986			1986 vs 1985		
	Total Change	Volume	Rate	Total Change	Volume	Rate
			(In thousands)			
Interest income:						
Loans receivable	$27,825	$38,130	$(10,305)	$(26,422)	$ (8,972)	$(17,450)
U.S. Government securities	(4,333)	(3,165)	(1,168)	18,581	21,452	(2,871)
Other investment securities	7,307	10,174	(2,867)	21,832	25,271	(3,439)
Other interest earning assets	(8,042)	(6,472)	(1,570)	20,262	24,794	(4,532)
Increase (decrease) in interest income	$22,757	$38,667	$(15,910)	$ 34,253	$ 62,545	$(28,292)

	1987 vs 1986			1986 vs 1985		
	Total Change	Volume	Rate	Total Change	Volume	Rate
			(In thousands)			
Interest expense:						
Deposits	$16,226	$30,977	$(14,751)	$ 36,062	$ 50,633	$(14,571)
FHLBB advances	(745)	(551)	(194)	(880)	(1,001)	121
Other borrowings	(3,603)	(2,528)	(1,075)	36,221	38,876	(2,655)
Increase (decrease) in interest expense	$11,878	$27,898	$(16,020)	$ 71,403	$ 88,508	$(17,105)
(Increase) decrease in gross interest cost	$10,879	$10,769	$ 110	$(37,150)	$(25,963)	$(11,187)

At December 31, 1987, Lincoln Savings' interest bearing liabilities exceeded its interest earning assets by $1,086,000,000. The impact of this differential between interest earning assets and interest bearing liabilities on net interest income is that, at December 31, 1987, a positive weighted average interest rate spread of 3.07% would have been required for interest income to be equal to interest expense at that date. At December 31, 1987, Lincoln Savings' actual weighted average interest rate spread was .94%. These differentials exclude the effects of certain income-producing real property, as described in footnote (1) to the following table, and certain other real property and investment securities which do not earn interest.

The following table sets forth, as of December 31, 1987, the amount of interest or dividend earning assets and the amount of interest bearing liabilities maturing or repricing in the periods indicated and their respective weighted average yields or rates at the end of these periods. The excess amount of assets or liabilities maturing or repricing is considered to be "unmatched." Asset and liability amounts are reflected in periods consistent with their stated maturity or repricing dates. No assumptions have been made with respect to future sales of any assets. Assets or liabilities with fixed interest rates are assumed to bear interest at their stated rates, unless they were acquired or issued at a premium or a discount in which case they are assumed to bear interest at their estimated yields to maturity. Variable rate assets and liabilities are assumed to bear interest at the interest rate in effect on December 31, 1987.

	1988				1989-1990	1991-1992	1993-1997	1998-2007	Thereafter	Total
	0-30	31-90	91-180	181-365						
					(Dollars in thousands)					
Assets(1):										
Loans and mortgage-backed securities(2)	$ 596,842	$ 33,069	$ 28,261	$ 14,838	$ 129,409	$ 122,410	$ 151,786	$ 41,679	$ 479,281	$ 1,597,575
	10.17	10.89	11.50	11.54	10.16	11.80	11.21	11.12	9.33	10.22
U.S. Treasury obligations	—	25,149	10,862	8,001	22,058	76	5,951	—	305,562	377,659
	—	5.56	5.99	6.24	6.29	4.25	7.46	—	7.18	6.97
Corporate and municipal bonds(3)	—	24,500	1,881	55,527	123,620	323,094	64,842	17,561	11,141	622,166
	—	8.91	8.13	10.84	13.38	12.37	11.73	13.81	9.10	12.20
Certificates of deposit, commercial paper and securities purchased under agreement to resell	333,518	215	400	135	—	—	—	—	—	334,268
	7.19	6.29	6.90	6.93	—	—	—	—	—	7.19
Cash and cash equivalents	170,388	—	—	—	—	—	—	—	—	170,388
	6.87	—	—	—	—	—	—	—	—	6.87
Total	$1,100,748	$ 82,933	$ 41,404	$ 78,501	$ 275,087	$ 445,580	$ 222,579	$ 59,240	$ 795,984	$ 3,102,056
Total yield(%)	8.76	8.68	9.86	10.50	11.30	12.21	11.26	11.92	8.50	9.71

	1988				1989-1990	1991-1992	1993-1997	1998-2007	Thereafter	Total
	0-30	31-90	91-180	181-365						
					(Dollars in thousands)					
Liabilities:										
Savings accounts(4) . . .	$ 682,663	$ 280,549	$ 448,609	$ 486,092	$ 639,465	$ 450,730	$ 386,423	$ —	$ —	$ 3,374,531
	6.33	7.42	7.74	8.45	10.53	11.13	11.11	—	—	8.90
Eurobond debt . .	—	275,000	100,000	—	—	21,023	—	—	—	396,023
	—	7.62	8.25	—	—	9.17	—	—	—	7.86
Real estate notes payable	6,980	116	—	12,487	15,227	8,749	26,922	375	—	70,856
	10.85	11.21	—	10.97	11.44	9.48	10.30	9.50	—	10.61
FHLB debt	—	—	—	—	—	—	25,000	—	—	25,000
	—	—	—	—	—	—	12.99	—	—	12.99
Reverse repurchase agreements	226,862	—	—	—	—	—	—	—	—	226,862
	7.35	—	—	—	—	—	—	—	—	7.35
Other	95,043	—	—	—	—	—	—	—	—	95,043
	9.02	—	—	—	—	—	—	—	—	9.02
Total	$1,011,548	$ 555,665	$ 548,609	$ 498,579	$ 654,692	$ 480,502	$ 438,345	$ 375	$ —	$ 4,188,315
Total yield(%)	6.84	7.52	7.83	8.51	10.55	11.01	11.17	9.50	—	8.77
Net Difference: Over (under) matched	$ 89,200	$ (472,732)	$ (507,205)	$ (420,078)	$ (379,605)	$ (34,922)	$ (215,766)	$ 58,865	$ 795,984	$(1,086,259)
Cumulative over (under) matched	$ 89,200	$ (383,532)	$ (890,737)	$(1,310,815)	$(1,690,420)	$(1,725,342)	$(1,941,108)	$(1,882,243)	$(1,086,259)	$(1,086,259)
Spread(%)	1.92	1.16	2.03	1.99	.75	1.20	.09	2.42	8.50	.94

(1) Does not include certain real estate investments and property, plant and equipment under construction on which interest expense is capitalized during periods of development or construction; such assets had a book value of $662,841,000 at December 31, 1987 .

(2) Balance does not include allowance for possible losses of $11,755,000. See "Loan Loss Reserves".

(3) Balance does not include allowance for possible losses of $5,237,000. See "Investment Activities—Lincoln Savings and the Company".

(4) The "0-30" category includes NOW, money market accounts and certain C.D.'s which reprice daily, in an aggregate amount at December 31, 1987 of $509,612,000 bearing interest at 6.04%, which have historically rolled over into future periods. Lincoln Savings believes that a significant portion of these accounts will be renewed into future periods if competitive interest rates are paid.

The following table sets forth information concerning yields earned by Lincoln Savings on its loans (excluding loan origination and commitment fees) and interest earning investment securities, the rates paid on its savings accounts and borrowings and the resulting spread at the dates indicated.

	December 31,		
	1987	1986	1985(1)
Weighted average yield on loans receivable	10.22%	11.48%	12.21%
Weighted average yield on interest earning investment securities and cash equivalents	9.17	9.21	9.40
Combined weighted average yield on loans and interest earning investment securities	9.71	10.06	10.61
Weighted average rate paid on savings accounts	8.90	9.17	9.94
Weighted average rate paid on borrowings	8.25	7.38	9.52
Combined weighted average rate paid on savings accounts and borrowings	8.77	8.84	9.86
Spread between combined weighted average yield earned on loans and interest earning investment securities and combined weighted average rate paid on savings accounts and borrowings (2)	.94	1.22	.75

(Footnotes on following page)

(Footnotes for preceding page)

(1) Includes the effect of purchase accounting valuations made at the date of acquisition. See "Management's Discussion and Analysis of Results of Operations and Financial Condition." The effects of purchase accounting adjustments had no significant impact on the spread at December 31, 1987 or 1986.

(2) The spread at the end of a period is not necessarily indicative of the spread for the period following since the weighted average yield earned and rates paid on loans, investment securities, savings accounts and borrowings change continuously, subject to market conditions.

Lending Activities

The following table summarizes Lincoln Savings' loan portfolio at the dates indicated:

	December 31,							
	1987		1986		1985		1984	
	(Dollars in thousands)							
Mortgage—conventional	$ 179,093	13%	$ 250,500	25%	$410,260	42%	$518,743	59%
Mortgage—acquisition and development	760,572	53	482,717	48	402,577	41	337,335	38
Mortgage—construction	225,790	16	138,086	14	104,526	10	5,980	1
Commercial, consumer and other	262,441	18	132,710	13	70,519	7	19,679	2
Total loans receivable before deductions ..	1,427,896	100%	1,004,013	100%	987,882	100%	881,737	100%
Less:								
Undisbursed amount .	(301,169)		(152,672)		(96,664)		(35,389)	
Purchase accounting and other discounts	(1,613)		(3,409)		(9,963)		(55,059)	
Allowance for possible losses.....	(11,755)		(13,046)		(10,100)		(789)	
Loans receivable, net...	$1,113,359		$ 834,886		$871,155		$790,500	

At December 31, 1987, Lincoln Savings had outstanding unfunded loan commitments of approximately $317,464,000, including $301,169,000 of loans in process.

Lincoln Savings' policy is to regularly monitor its acquisition, development and construction loans in order to restrict loan disbursements and to maintain loan-to-value ratios acceptable to Lincoln Savings. However, there can be no assurance that Lincoln Savings would be able to recover its advances to any borrower or the accrued interest thereon upon foreclosure of a mortgage or upon demand for payment from guarantors.

Outside independent appraisals are reviewed and approved internally by a qualified MAI appraisal staff. If such appraisals are not approved, or satisfactory adjustments or reappraisals are not received, the loans are not made. If inadequate appraisals are relied upon, a risk of loss exists to the extent amounts funded exceed the actual value of the underlying security. Lincoln Savings requires title insurance insuring the priority of Lincoln Savings' liens for all of its loans secured by real property and, where applicable, generally requires fire and extended casualty insurance at least equal to the loan amounts.

Lincoln Savings has the potential for additional revenues on approximately $231,000,000 principal amount of loans at December 31, 1987, typically in the form of participations in profits which may be realized upon the sale or refinancing of the related real property. Repayment of loans and realization of any additional revenues is generally expected to occur from the proceeds of construction or permanent financing obtained by the borrower, or from the sale of property. Loans originated generally do not have permanent financing or sale commitments at the time of loan origination. There can be no assurance that any significant additional revenues from profit participations will be realized.

The following table summarizes Lincoln Savings' commercial real estate loans at December 31, 1987.

	Total		
	Number Of Loans	Gross Commitment	Actual Disbursed(1)
Hotels	3	$ 17,599,000	$ 17,599,000
Office	4	14,561,000	14,561,000
Apartment and other multi-family	9	42,948,000	33,718,000
Other commercial	79	69,600,000	67,568,000
Total	95	$144,708,000	$133,446,000

	Loans with equity participations		
	Number Of Loans	Gross Commitment	Actual Disbursed
Hotels	1	$ 12,419,000	$ 12,419,000
Apartment and other multi-family	2	13,347,000	11,730,000
Shopping centers and other	4	23,773,000	22,673,000
Total	7	$ 49,539,000	$ 46,822,000

(1) Includes 26 loans aggregating $97,983,000 which were originated by Lincoln Savings since its acquisition by the Company in February 1984.

Interest rates charged on Lincoln Savings' loans are determined primarily by reference to its asset/liability management and interest spread objectives, the demand and competition for loans, the availability to Lincoln Savings of funds for lending purposes, and yields available to Lincoln Savings from alternate investment opportunities. These factors are in turn affected by general economic conditions and such other factors as monetary policies of the federal government, including the Federal Reserve Board, the general supply of money in the economy, legislative tax policies and governmental budgetary matters.

The percentage of Lincoln Savings' loan portfolio (not including mortgage-backed securities) bearing interest at variable rates was 62% at December 31, 1987. The variable rate loans made by Lincoln Savings had rates at December 31, 1987 ranging from 8.5% to 13.25% and generally provide for the interest rate on the loan to fluctuate monthly with changes in the prime commercial lending rate of a specified commercial bank or the cost of funds to Lincoln Savings.

The following table sets forth the outstanding principal balance of variable rate and fixed rate loans at the dates indicated.

	December 31,					
	1987		1986		1985	
	(Dollars in thousands)					
Variable rate	$ 694,563	62%	$394,053	46%	$452,281	51%
Fixed rate	432,164	38%	457,288	54%	438,937	49
Total (1)	$1,126,727	100%	$851,341	100%	$891,218	100%

(1) Amounts represent total loans receivable less undisbursed amounts. Mortgage-backed securities, which are not included in the table above, totaled $472,461 at December 31, 1987, all of which had fixed rates.

The following table sets forth the outstanding principal balance and scheduled loan maturities of Lincoln Savings' loan portfolio as of December 31, 1987.

	Due in One Year or Less	Due in Years Two Through Five(2)	Due After Five Years(2)	Total(1)
		(In thousands)		
Acquisition and Development ...	$148,705	$280,514	$177,329	$606,548
Construction ...	68,170	27,382	—	95,552
Commercial ...	78,576	118,465	47,776	244,817
	$295,451	$426,361	$225,105	$946,917

(1) Amounts represent total loans receivable less undisbursed amounts and excludes conventional mortgages of $179,093,000 and loans to foreign countries of $717,000.
(2) Loans due after one year consist of $369,189,000 (57%) with variable interest rates and $282,277,000 (43%) with fixed interest rates.

Lincoln Savings' mortgage loans typically range from $1,000,000 to $15,000,000 and have been primarily for the acquisition, development or construction of real property. Eighty percent of all outstanding loans funded since acquisition require borrowers to pay interest currently over the life of the loan. Lincoln Savings generally does not make long-term level payment loans; virtually all loans made since the acquisition require "balloon" payments of principal at various points up to, and including, final maturity of the loan.

Commercial mortgage loans and acquisition, development and construction loans are generally believed to involve greater credit risk than residential mortgage loans; these loans typically involve larger loan balances to single borrowers or groups of related borrowers and may also involve higher ratios of loan principal amount to appraised value of the security property. On a commercial mortgage loan, the borrower is dependent on the future income stream from the project in order to retire the debt or to support its value; operation of the related real estate project may be affected by adverse conditions in the real estate market or in the economy generally. The security for land acquisition and development loans does not produce income, and the loan is typically made on the basis of a development plan which contains revenue and profit forecasts which may not be attained; risks associated with these loans include disapproval of development by governmental agencies, environmental problems, cost overruns, poor market conditions and negative cash flow. Lincoln Savings' management believes that its direct experience in land acquisition and development and the development of commercial projects is an important factor in its ability to evaluate, and therefore to minimize, these risks. See "Business—Real Estate Activities." Lincoln Savings has undertaken not to originate any acquisition, development or construction loans pending further discussion with the California Savings and Loan Commission. See "Business—Regulation—Federal Home Loan Bank—FHLBB Examination."

Lincoln Savings' management believes that, at December 31, 1987, Lincoln Savings was in compliance with the rules and regulations promulgated by the FHLBB and the California Department of Savings and Loan regarding appraisals and loan-to-value ratios, which set forth the standards for appraisals and limit loan-to-value ratios to amounts acceptable to the management of the association, but not to exceed 100%. The following are the weighted average loan-to-value ratios for mortgage loans which were outstanding at December 31, 1987:

Type of Collateral	Gross Commitment	Weighted Average Loan-to-Value
Hotels ...	$ 17,599,000	95%
Office ...	14,561,000	69%
One-to-four residential ...	208,113,000	89%
Apartment and other multi-family ...	42,948,000	85%
Shopping centers and other commercial ...	46,676,000	64%
Other, principally acquisition, development and construction ...	760,572,000	77%

Lincoln Savings generally requires an equity investment from the borrower over the life of the loan in the form of cash or contributed assets, in an amount which Lincoln Savings considers prudent and appropriate depending upon the individual circumstances of the loan. Factors considered by Lincoln Savings include the creditworthiness of the borrower, the real estate experience of the borrower or its principals, and the amount of additional collateral pledged to secure the loan. Although Lincoln Savings does not rely on the value of personal guarantees in determining the loan-to-value ratio which is prudent for a particular loan, it frequently requires loan guarantees by the principals of the borrower for all or a portion of the loan; in most of these circumstances, the net worth of the guarantor will be at least equal to the loan amount. Of the $1,090,469,000 of loans included in the above table, Lincoln Savings has personal guarantees with respect to approximately $625,806,000, including approximately $420,973,000 included in the "Other" category.

Origination, Purchase and Sale of Loans and Mortgage-Backed Securities. Lincoln Savings originates loans for its own portfolio and for sale to investors to generate funds for further lending and liquidity. The following table summarizes the loan origination and purchase and sales activity of Lincoln Savings during the periods indicated.

	Year ended December 31,		
	1987	1986	1985
		(In thousands)	
Loans originated:			
Mortgage—conventional	$ 18,653	$ 13,510	$ 43,313
Mortgage—acquisition and development	543,795	376,827	249,461
Commercial, consumer and other	182,850	85,020	81,890
Construction	206,902	76,035	95,234
Increase in loans in process	(148,497)	(56,008)	(61,275)
Total loans originated	803,703	495,384	408,623
Purchase (sales):			
Loans	84,018	42,535	131,310(1)
	(56,563)	(111,559)	(287,435)
Mortgage-backed securities	998,589	920,604	1,067,173
	(593,263)	(911,833)	(1,446,445)
Total loans originated and purchased, net of sales	1,236,484	435,131	(126,774)
Other:			
Principal repayments and refinances	(510,079)	(427,985)	(167,021)
Other charges and credits, net	(42,606)	(34,644)	(4,822)
Net increase (decrease) in loans receivable and mortgage-backed securities	$ 683,799	$ (27,498)	$ (298,617)

(1) Consists primarily of loans acquired by the Company in connection with its acquisition of Lincoln Savings.

Loan Loss Reserves

Valuation allowances for estimated loan losses are charged to operations based on periodic reviews of the carrying values and net realizable values of the loans. Generally, Lincoln Savings' policy is to provide general loan loss reserves in addition to loss reserves for specific loans when management determines that the value of the collateral securing the specific loans has declined to an amount less than the carrying value of the loan. At December 31, 1987, Lincoln Savings' consolidated loan loss reserve was $11,755,000.

The change in allowances for possible loan losses is summarized as follows:

	1987	1986	1985	1984
		(In thousands)		
Balance at beginning of period	$13,046	$10,100	$ 789	$ 459
Additional provisions	5,669	3,643	8,888	330
Charge-offs	(360)	(697)	—	—
Reclassification	(6,600)	—	423	—
Balance at end of period	$11,755	$13,046	$10,100	$ 789

As of December 31 of the identified years, Lincoln Savings had certain loans which were not in conformance with the original terms of the loan agreement or had been restructured to terms which would otherwise be unacceptable under Lincoln Savings' normal lending practices. These loans, although not directly reflected in Lincoln Savings' loan loss reserve, do factor into its judgment in determining the amount of its loan loss reserve. Other factors include market analysis, property condition, leasing status (on income-producing properties) and current appraised values. The following is a summary of such loans:

	December 31,			
	1987	1986	1985	1984
	(In thousands)			
Non-accruing loans	$12,579	$17,096	$21,605	$ 0
Accruing loans more than 90 days delinquent	2,357	5,956	16,178	3,929
Restructured loans	33,508	32,922	8,449	0

Interest income recorded from these loans during 1987 was $4,894,000. If the loans had been current in accordance with their original terms, interest income during 1987 would have been $5,573,000.

Classification of Assets

Effective December 31, 1987, the FHLBB amended existing regulations providing for the classification of loans and other assets that are considered to be of questionable quality. The classification system adopted by the FHLBB on December 31, 1987 is intended to be consistent with that used by the Federal banking agencies; the regulations, as amended, employ the existing classification categories of Substandard, Doubtful and Loss, but alter the consequences of these classifications with respect to valuation allowance requirements (reserves) and their effect on regulatory capital. Assets classified as Substandard or Doubtful now require the establishment of general valuation allowances in amounts consistent with Generally Accepted Accounting Principles (GAAP); assets classified as Loss require either a specific valuation allowance of 100% of the amount classified, or a charge-off of such amount.

The amended regulations require all insured institutions, including Lincoln Savings, to classify their own assets on a regular basis and to establish valuation allowances as appropriate. FHLBB examiners will review the institution's classifications in light of the examiners' perceptions of the quality of specific assets and their evaluation of the overall quality of the institution's asset portfolio. The examiners may conclude that, with respect to assets self-classified by the institution as Substandard or Doubtful, the general valuation allowances are inadequate and higher general valuation allowances should be established, or that certain assets should be classified as Loss; any recommendation by the examiners is subject to the approval of the institution's FHLBB Principal Supervisory Agent.

Lincoln Savings has undertaken classification of its assets and has established general valuation allowances. The following table sets forth information at December 31, 1987 relating to Lincoln Savings' general and specific valuation allowances established in accordance with the amended regulations:

Classification of Assets	Valuation Allowances	Balance at December 31, 1987 (In thousands)
Substandard and Doubtful	General	$27,651
Loss	Specific	$18,269

In connection with the 1988 examination of Lincoln Savings by the FHLBB, the valuation allowances listed above may be reviewed by the examiners; the general and specific valuation allowances established by Lincoln Savings may be increased if the examiners believe them to be inadequate.

Investment Activities—Lincoln Savings and the Company

Lincoln Savings has diversified its investment portfolio to include substantial investments in United States Government securities, mortgage-backed securities, corporate debt and equity securities and cash equivalents. Through diversification of investments, Lincoln Savings has been able to obtain yields greater than those available on mortgage loans while making Lincoln Savings' profitability less dependent on interest income or loan origination fees. The decision to make a particular investment is based on a variety of factors, including a credit analysis and an appraisal of the economic potential of the issuer.

The Company (excluding Lincoln Savings and its subsidiaries) has expanded its own investment securities activities. In 1987, the Company began to actively trade in the cash and futures markets, including investments in foreign currencies, Eurodollars, commodities and domestic and foreign debt and equity securities. The Company expects that its investment activities will be significant to the Company's future results of operations.

The Company's consolidated investment securities at December 31, 1987, 1986 and 1985 consisted of the following:

	1987(1)		1986	1985
	Cost	Estimated Market Value	Cost	Cost
	(In thousands)			
Certificates of deposit and commercial paper	$ 318,994	$ 318,994	$ 127,718	$170,544
Bonds:				
U.S. treasury and government agencies	422,243	345,035	727,997	11,950
Corporate bonds	622,166	560,703	370,861	246,756
Allowance for possible losses	(5,237)	—	(4,900)	(2,500)
	1,039,172	905,738	1,093,958	256,206
Marketable equity securities:				
Preferred stocks	48,055	45,075	32,761	36,929
Common stocks, warrants to purchase common stock and other equity securities	154,844	123,995	77,328	56,033
Reserve for lower of cost or market	(33,829)	—	(12,632)	(2,083)
	169,070	169,070	97,457	90,879
Total investment securities(1)	$1,527,236	$1,393,802	$1,319,133	$517,629

(1) The Company's (excluding Lincoln Savings and its subsidiaries) investment securities were $71,347,000, $29,431,000 and none at December 31, 1987, 1986 and 1985, respectively. These investment securities at December 31, 1987 included $44,584,000 of U.S. Treasury bills, $234,000 of preferred stock, $11,137,000 of common stock and $15,392,000 of certificates of deposit and commercial paper. Estimated market value approximated cost on all such investments.

At December 31, 1987, the gross unrealized gains and losses in the marketable equity securities portfolio were $5,691,000 and $39,520,000, respectively.

At December 31, 1986 and 1985, the market value of investment securities was $1,281,512,000 and $514,487,000, respectively.

The following table sets forth consolidated investment securities, exclusive of allowance for possible losses of $5,237,000, by maturity and their weighted average yields as of December 31, 1987.

	Within One Year	After One Year Through Five Years	After Five Years Through Ten Years	After Ten Years	Total
	(Dollars in thousands)				
U.S. Treasury and government agencies	$ 88,596	$ 22,134	$ 5,951	$305,562	$ 422,243
	5.69%	6.28%	7.46%	7.19%	6.83%
Corporate bonds	81,908	446,714	64,842	28,702	622,166
	10.20	12.65	11.73	11.98	12.20
Certificates of deposit and commercial paper	318,994	—	—	—	318,994
	7.27				7.27
Total(1)	$489,498	$468,848	$70,793	$334,264	$1,363,403
Weighted average interest rate	7.48%	12.35%	11.37%	7.60%	9.39%

(1) Excludes marketable equity securities which do not provide a current yield.

Lincoln Savings owned $622,166,000 principal amount of corporate debt securities at December 31, 1987, substantially all of which securities are rated less than investment grade, with a weighted average yield of 12.20% and weighted average maturity of 8.9 years; of such corporate debt securities, $596,390,000 (weighted average yield of 12.33%) had fixed interest rates and $25,776,000 (weighted average yield of 9.41%) had variable interest rates. Risk of loss upon default on such corporate debt securities is generally greater than that upon default of mortgage loans because the corporate debt securities are typically unsecured and some are subordinated to other debt of the borrower.

Under California law and regulations, Lincoln Savings may make unlimited investments in corporate bonds which are marketable and not predominantly speculative in nature, and may invest an aggregate of up to 5% of its assets in other corporate bonds, equity securities and other investments not specified in the law (such specified investments include real estate loans, government securities and mortgage-backed securities). Additional investments may be made by Lincoln Savings through its service corporations with the approval of the California Savings and Loan Commissioner. See "Investments in Service Corporations." Under Federal regulations, Lincoln Savings' (excluding subsidiaries) commercial loans (including corporate bonds) to one borrower cannot exceed 15% of Lincoln Savings' consolidated net worth. Regulations adopted by the FHLBB in January 1985 limit Lincoln Savings' ability to invest in additional corporate equity securities; however, these regulations do not restrict its subsidiaries from making these investments under certain conditions. See "Regulation—Federal Home Loan Bank."

Real Estate Development—Lincoln Savings

One of the new investment policies implemented by Lincoln Savings following its acquisition by the Company was to increase its investment in real estate held for development and sale. Lincoln Savings engages in the acquisition of undeveloped land, the creation and implementation of site development plans and the improvement of the land for future construction. Lincoln Savings has emphasized the acquisition of land which offers potential for profitable development into mixed-use planned communities. The development of a mixed-use planned community generally involves the acquisition of a large tract of land, site plan development, obtaining mixed-use zoning and, if necessary, annexation of the land into a municipality. Depending on market conditions, Lincoln Savings may build commercial buildings (including hotels, apartment complexes, shopping centers and office buildings) on portions of the tracts and sell part of the tracts to others.

Lincoln Savings had investments in real estate totaling approximately $827,300,000 at December 31, 1987, including approximately $487,800,000 in Arizona, $104,600,000 in Colorado, $142,300,000 in Texas, and $63,000,000 in Georgia. For additional information on real estate development by Lincoln Savings and the Company, see "Business—Real Estate Activities."

Since real estate development often requires a longer period than other investments before a return can be realized, Lincoln Savings' liquidity and ratio of earnings to fixed charges could be adversely affected in the future if it is forced to rely on short-term borrowings for such activities. These real estate investments are generally non-interest earning assets and therefore adversely affect Lincoln Savings' net interest income. See "Management's Discussion and Analysis of Results of Operations and Financial Condition."

In its agreement with the FHLBB concerning its 1986 examination, Lincoln Savings has agreed generally not to increase its investment in real estate in 1988. See "Regulation—Federal Home Loan Bank—FHLBB Examination."

Sources of Funds

Savings Accounts. The following table shows the distribution of Lincoln Savings' savings accounts by type of account at the dates indicated.

	Weighted Average Stated Interest Rate at December 31, 1987	December 31,					
		1987		1986		1985	
				(Dollars in thousands)			
		Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount
Passbook accounts	5.50%	1%	$ 43,985	2%	$ 61,958	2%	$ 54,434
NOW checking accounts	5.20	3	110,745	4	120,562	5	121,981
Money market savings accounts	6.37	11	354,882	9	256,057	3	69,835
Certificate accounts (2):							
Retail	9.48	81	2,730,884(1)	80	2,242,904	83	2,005,130
Jumbo	7.95	4	134,035	5	139,894	7	155,578
Total savings accounts	8.90%	100%	$3,374,531	100%	$2,821,375	100%	$2,406,958

(1) Includes $1,582,794,000 of nonwithdrawable certificate accounts with a weighted average stated interest rate of 10.46% marketed through brokerage firms.

(2) Certificate accounts at December 31, 1987 are summarized by maturity as follows:

	Principal amount (in thousands)	Weighted Average Interest Rate
0-3 months	$ 453,587	7.333%
3-6 months	448,609	7.741%
7-12 months	486,092	8.452%
13-18 months	204,561	10.532%
19 months and longer	1,272,070	10.877%
	$2,864,919	

The increase in savings accounts reflects Lincoln Savings' efforts to increase significantly its principal source of funds and to extend the maturities of such accounts by increasing marketing efforts through branch offices and by marketing insured, nonwithdrawable certificate accounts through several national brokerage firms. The certificate accounts marketed through brokerage firms represent 55% of total certificate accounts at December 31, 1987, and cannot be withdrawn prior to remaining maturity except upon the death or legal incompetency of the holder. The majority of these certificates have

remaining maturities of up to 11 years. At December 31, 1987, 44% of Lincoln Savings' savings accounts had maturities greater than one year compared to 11% at the date of acquisition by the Company.

The table below sets forth the average amount outstanding and the average rate paid on the following deposit categories.

	1987		1986		1985	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
			(Dollars in thousands)			
Savings deposits	$ 386,031	6.06%	$ 157,785	5.60%	$ 121,795	6.62%
Time deposits	$2,499,496	9.85%	$2,382,879	10.21%	$1,899,833	10.89%

The following table indicates the distribution of Lincoln Savings' certificate accounts at December 31, 1987 by maturity.

Maturity	Amount (in thousands)	Percent of Total
Less than 30 days	$ 173,038	6%
More than 30 days and prior to December 31, 1988	1,215,250	42
Year ending December 31, 1989	349,305	12
Year ending December 31, 1990	290,173	10
Year ending December 31, 1991	250,080	9
Year ending December 31, 1992	200,650	7
After December 31, 1992	386,423	14
Total	$2,864,919	100%

The stability of the Company's supply of lendable funds, and therefore its ability to better match the rate sensitivity of its assets and liabilities, is also affected by savings accounts which cannot be withdrawn early without penalty. At December 31, 1987, 97% of certificate accounts could not be withdrawn except upon the death or legal incompetency of the depositor and the remaining 3% could not be withdrawn without penalty.

Borrowings. The following table sets forth certain information as to Lincoln Savings' borrowings at the dates indicated.

	December 31,		
	1987	1986	1985(1)
		(Dollars in thousands)	
FHLB advances	$ 25,000	$ 45,868	$ 53,145
Mortgage-backed notes (net of discount)	—	2,439	33,288
Collateralized floating rate notes	375,000	436,000	375,000
Collateralized fixed rate notes	21,023	—	—
Reverse repurchase agreements	226,862	—	—
Other borrowings	165,899	145,583	108,740
Total borrowings	$813,784	$629,890	$570,173
Total borrowings as a percentage of savings accounts	24.1%	22.3%	23.7%
Weighted average interest rate on total borrowings at the end of the period	8.3%	7.4%	9.5%

(1) See Notes (K) and (L) to the Company's Consolidated Financial Statements for information regarding maturities.

The FHLB system functions in a reserve credit capacity for member savings and loan associations and certain other home financing institutions. As a member, Lincoln Savings is required to own capital stock in the FHLB of San Francisco and is authorized to apply for advances from the FHLB of San Francisco on the security of such stock and certain of its home mortgage loans and other assets.

Lincoln Savings also uses, from time to time, "reverse repurchase agreements" as a source of short-term funds. Reverse repurchase agreements consist of sales of securities by Lincoln Savings with concurrent commitments to repurchase the securities at a predetermined price at a future date, typically ranging from one to seven days after the date of the initial sale. Lincoln Savings enters into such agreements only with national primary broker-dealers. Average borrowings under reverse repurchase agreements during 1987 (with a maximum month-end balance of $537,717,000) were $229,277,000 at a weighted average interest rate of 7.07%; $226,862,000 was owed under such agreements at December 31, 1987.

In December 1984, Lincoln Savings sold in a Eurobond offering $100,000,000 principal amount of Collateralized Floating Rate Notes, collateralized primarily by GNMA Certificates. During 1987, the outstanding balance of this debt was retired.

In November 1985 and April 1986, LINFIN Corporation, a wholly-owned limited purpose subsidiary of Lincoln Savings, sold in Eurobond offerings $275,000,000 and $100,000,000, respectively, aggregate principal amount of Collateralized Floating Rate Notes, collateralized by certain types of mortgage-backed certificates and money market instruments, securities of the United States Treasury and cash. These Notes are obligations solely of LINFIN and are not obligations of, or guaranteed by, Lincoln Savings. LINFIN and Lincoln Savings are jointly and severally obligated to maintain the value of the collateral at specified levels.

In July 1987, Lincoln Savings sold in a Euroyen offering ¥7,000,000,000 (approximately $48,231,000) principal amount of Collateralized Fixed Rate Notes, collateralized primarily by cash. Approximately $28,000,000 of this debt was retired in 1987.

Investments in Service Corporations

Lincoln Savings has twelve service corporation subsidiaries; these subsidiaries had total assets at December 31, 1987 of approximately $2.6 billion. Each of these service corporations was formed and operates pursuant to an agreement with the California Savings and Loan Commissioner; the amount which Lincoln Savings may invest in each service corporation is subject to approval by the California Commissioner. The California Commissioner may restrict the operating powers of a service corporation at any time.

The service corporations engage in various businesses, including insurance and the construction, ownership and management of hotels and other residential and commercial real estate projects.

Regulations adopted by the FHLBB in January 1985 and April 1987 restrict, with certain exceptions, Lincoln Savings' ability to invest in service corporations and certain other investments. See "Business—Regulation—Federal Home Loan Bank."

Insurance

Lincoln Savings has subsidiaries which underwrite life insurance and act as general agents and brokers in personal, commercial, life and health insurance markets.

Continental Fidelity Life Insurance Company ("CFLIC"), a subsidiary of one of Lincoln Savings' service corporations, underwrites life insurance and is licensed in Arizona. CFLIC had revenues of $753,000, $1,057,000 and $1,423,000 in 1987, 1986 and 1985, respectively. On January 28, 1986,

CFLIC acquired American Founders Life Insurance Company ("AFL") for a cash purchase price of approximately $58,700,000. AFL is a Texas-based insurance company with approximately $280,000,000 in assets; its product lines, which include universal life, term life and annuity policies, are marketed through independent agents located in 36 states and the District of Columbia, with a heavy concentration of business in the Western and Southwestern United States. AFL's 1987 revenues and net earnings were $54,055,000 and $5,205,000 (including $2,495,000 from the cumulative effect of a change in accounting for income taxes), respectively. In 1986, AFL's revenues and net earnings were approximately $82,110,000 and $6,528,000, respectively. The 1987 decrease in revenues and net earnings resulted principally from management's decision to withdraw from the market a variable annuity product (marketed primarily in California) and changes in the agency force resulting from the acquisition.

Insurance West, Inc. was incorporated by the Company in Arizona in 1980 and became a wholly-owned service corporation subsidiary of Lincoln Savings in 1984. Insurance West is an independent agency and broker for personal and commercial insurance, which writes insurance business through some of the leading insurers in the United States. In 1987, Insurance West generated revenues of approximately $2.8 million, consisting of commissions on premiums in excess of $24 million.

Competition

Lincoln Savings experiences intense competition both in attracting savings accounts and making real estate loans. In attracting savings accounts, Lincoln Savings must compete against investment opportunities offered by savings and loan associations, commercial banks, credit unions, thrift and loan companies, corporations, the United States government and governmental agencies, and money market mutual funds, among others. Lincoln Savings competes for these funds on the basis of interest rates paid, safety and liquidity of investments. The principal methods used by Lincoln Savings to attract savings include advertising, readily accessible office locations and the quality of service to its customers. However, competition for savings in California is particularly strong from large commercial banks because of their ability to provide a broader range of consumer services and their large branch networks. Competition in making real estate loans comes principally from other savings and loan associations, commercial banks, mortgage companies, insurance companies and government agencies. Lincoln Savings competes for loans primarily through the interest rates and terms offered and loan fees charged, and the efficiency, convenience and quality of services provided.

AFL and CFLIC function in a highly competitive life insurance market which is comprised of over 2,000 insurers. AFL and CFLIC compete for business by placing emphasis on quality insurance products, service to policyholders, and attractive compensation packages for agents.

Insurance West experiences extreme competition in its market for insurance brokerage and agency services. Insurance West competes for insurance business by placing emphasis on the maintenance of a well-trained, professional staff, quality of service provided to its clients, and affiliation with leading insurance companies.

REGULATION

General

AMCC and First Lincoln Financial Corporation, a wholly-owned subsidiary of AMCC and parent of Lincoln Savings, are savings and loan holding companies. They are currently registered as such with the Federal Savings and Loan Insurance Corporation ("FSLIC") and the California Savings and Loan Commissioner (the "California Commissioner"), and are subject to comprehensive regulation, examination, supervision and reporting requirements. Federal law restricts, among other things, the amount of debt that AMCC may incur.

Lincoln Savings is a California licensed savings and loan association which is a member of the FHLB of San Francisco and has its deposit accounts insured by the FSLIC. It is subject to examination and supervision by the California Department of Savings and Loan as a California licensed savings and loan association and by the FSLIC. Lincoln Savings is also subject to the regulations of the FHLBB and the Federal Reserve Board.

California Law and Regulation

As a California-licensed savings and loan association, Lincoln Savings operates under the California Savings Association Law and is subject to comprehensive examination, supervision and regulation by the California Commissioner thereunder. This law and applicable regulations place certain restrictions on Lincoln Savings' investments, borrowings, loans, issuances of securities, payments of interest and dividends and establishment of branch offices, and obligate Lincoln Savings to prepare and file various records and reports. California law is less restrictive with respect to the payment of dividends than the agreement AMCC reached with the FHLBB in connection with the acquisition of Lincoln Savings, and authorizes significantly broader investment powers than are permitted by current FHLBB regulations. See "Regulation—Federal Home Loan Bank." Under California law, Lincoln Savings must maintain its statutory net worth at not less than 3% of its total assets (as defined). At December 31, 1987, Lincoln Savings believes it exceeded the minimum requirement by approximately $139,000,000. Lincoln Savings has undertaken not to originate any acquisition, development or construction loans pending further discussion with the California Savings and Loan Commission.

The California Commissioner also has the power to take control of the assets and business of, and to liquidate or reorganize, an association upon a finding that it is conducting its business in an unsafe or injurious manner, that its assets are below certain required levels relative to capital and savings accounts, or in certain other unusual circumstances.

Federal Home Loan Bank

Lincoln Savings, as a member of the FHLB of San Francisco, is required to acquire and hold shares of capital stock in that Bank in an amount at least equal to 1% of the aggregate principal amount of its unpaid residential mortgage loans, home purchase contracts, and similar obligations as of the close of each calendar year, or 1/20 of its advances (borrowings) from the FHLB of San Francisco, whichever is greater. Lincoln Savings was in compliance with this requirement at December 31, 1987, with an investment in FHLB of San Francisco stock of $4.4 million.

As a member of the FHLB system, Lincoln Savings is required to maintain liquid assets equal to 5% of its deposits and short-term borrowings, and short-term liquid assets equal to at least 1% of its deposits and short-term borrowings. Noncompliance may lead to various money penalties imposed by the FHLBB. As a member of the FHLB system with deposits insured by the FSLIC, Lincoln Savings is subject to comprehensive regulation, examination and supervision by the FHLBB on behalf of the FSLIC. From time to time the FHLBB proposes, or announces its intention to propose, new regulations which, if adopted, could have a significant effect on Lincoln Savings' operations. The FHLBB may also impose certain requirements with respect to, among other items, capital levels and valuation allowances on an institution-by-institution basis. Lincoln Savings' management believes that Lincoln Savings met this requirement throughout 1987.

The ability of Lincoln Savings to pay dividends on its common stock is restricted by FHLBB regulations and by an agreement with the FHLBB entered into in connection with the acquisition by AMCC. Under that agreement, without prior written approval from the FHLBB, dividends paid by Lincoln Savings in any fiscal year are limited to 50% of its net income for that fiscal year, provided that any dividends permitted under this limitation may be deferred and paid in a subsequent year, subject to the provision that in no event may dividends be paid which, in fact or in the opinion of the FHLBB, would cause Lincoln Savings to fail to meet its minimum capital requirements. In addition, until the

earlier of the completion of its next periodic examination and resolution of any issues raised thereby or December 20, 1988, Lincoln Savings has agreed with the FHLBB that Lincoln Savings will not pay any dividends unless it notifies the FHLBB at least two weeks prior to the proposed payment and the FHLBB does not object. At December 31, 1987, approximately $65,000,000 of Lincoln Savings' retained earnings were available for the payment of dividends. See "—FHLBB Examination" below.

FSLIC Regulation. Deposits in the accounts of Lincoln Savings which qualify are each insured up to a maximum of $100,000. The FSLIC requires an annual audit by independent accountants and periodically makes its own examination of associations whose deposits are insured. It may revalue the assets of an association, based upon appraisals, and require establishment of specific reserves in amounts equal to the difference between such revaluation and the book value of the assets.

FSLIC-insured institutions, such as Lincoln Savings, are required to maintain a minimum amount of regulatory capital (previously referred to as "regulatory net worth" or "net worth"), effectively limiting the rate by which an association may increase its liabilities. The growth limitations imposed by the regulatory capital requirement may affect Lincoln Savings' ability to compete with larger savings institutions that possess greater growth abilities under the regulatory capital requirement as a result of their total size, as well as with other financial institutions that are not subject to the same requirement.

Prior to March 1985, FSLIC regulations required a savings institution to maintain a minimum regulatory net worth equal to a percentage (3% for fiscal years 1982 through 1984 and 4% for fiscal year 1981) of the average of substantially all liabilities of the institution outstanding on a specified date in the prior year and on such date in one or more of the four immediately preceding years, plus 20% of scheduled items and, beginning in 1982, 2% of the unpaid principal balance of loans sold with recourse. Compliance with the minimum net worth requirement was determined as of the annual closing date of the year.

Regulations effective March 1985 revised the method of calculating the minimum regulatory capital requirement and would have gradually eliminated a savings institution's ability to calculate its net worth requirement by reference to its average liabilities. The regulation also changed the determination of, and the requirement for compliance with, the minimum net worth requirement from an annual basis, at the beginning of each fiscal year, to a quarterly basis at the end of each calendar quarter. The regulation required the minimum net worth requirement to be increased quarterly by an amount equal to a percentage of the increase in liabilities (based upon average liabilities if an institution's liabilities did not increase by a rate that exceeded a 10% annual rate) as measured from the end of the preceding year, with the applicable percentage ranging from 3% to 5% depending upon the rate of growth. This regulation also permitted the minimum net worth requirement to be decreased in the last quarter of a fiscal year to reflect a year-to-date decrease in liabilities. Minimum net worth included 2% of the unpaid principal balance of loans sold with recourse plus 20% of scheduled items. A FSLIC-insured institution with assets in excess of $100.0 million was required under the regulation to obtain prior approval from its Principal Supervisory Agent (the "PSA") before increasing liabilities in any two consecutive quarters at an annual rate in excess of 25%.

In January 1987, new FSLIC regulations (the "1987 Regulations") were adopted. Among other things, the 1987 Regulations require an increase over time of a savings institution's capital requirements to 6% of total liabilities, subject to certain risk-related adjustments ("contingency factors"). Savings institutions were required to compute and satisfy the capital requirements in accordance with the 1987 Regulations for the first time on March 31, 1987. For liability levels existing on January 1, 1987 ("Base Liabilities"), the 1987 Regulations require a savings institution to increase its existing regulatory capital on a periodic basis over a transition period until its capital equals 6% of its liabilities. Each periodic incremental increase required by the 1987 Regulations will be based on the savings and loan industry's annual profits, expressed as a ratio of average rate of return on assets. A savings institution will be required to increase its regulatory capital on Base Liabilities at varying percentages depending on the amount of its net worth requirement as of December 31, 1986. The transition period, as

determined by the industry's profitability, currently is anticipated to be between 6 and 12 years. The 1987 Regulations required immediate capitalization at 6% for liability growth on or after January 1, 1987. The capital requirement is subject to increase for contingency factors based on the percentages of specified investments held by an institution. Such investments include scheduled items, recourse liabilities, standby letters of credit, equity risk investments, certain loans for unimproved real estate and non-residential construction loans. Such increases are determined by reference to the amount of an institution's regulatory capital and the extent of such investments as a percentage of total assets. The capital requirement is also subject to certain credits, reflecting an institution's interest rate risk exposure, i.e., the lower the interest rate risk exposure (as measured by the difference between maturities of assets and liabilities), the greater such credit. Such credits may not, however, reduce an institution's regulatory capital requirement below 3% up to January 1, 1990 and not below 4% thereafter.

If an institution fails to meet its FSLIC capital requirement, the FSLIC may cause the institution to take such actions as the FSLIC may deem appropriate for the protection of the FSLIC, the institution or depositors or investors in the institution. Sanctions imposed may include an elimination or reduction of dividends and budgetary controls. At December 31, 1987, Lincoln Savings believes its minimum regulatory capital requirement was $113,458,000; Lincoln Savings believes it exceeded this requirement by approximately $139,000,000. If Lincoln Savings' agreement with the FHLBB described in "—FHLBB Examination" below had been in effect on December 31, 1987, Lincoln Savings' minimum capital requirement would have been $125,950,000.

Under current FSLIC regulations, the entire principal amount of each series of Debentures would be includable in Lincoln Savings' regulatory capital when the years to maturity of such series were greater than or equal to seven. Thereafter, in accordance with a FSLIC schedule for the amortization of the principal amount of the Debentures included in regulatory capital, the principal amount includable will decrease each year by approximately one-seventh of the principal amount of such series initially issued.

The 1987 Regulations retained prior growth rate regulations, which require prior approval by an institution's PSA for growth in any two consecutive quarters at a rate higher than 25% annually. However, the 1987 Regulations rephrased the prior requirement to prohibit an institution from increasing its total liabilities within any two-quarter period at a rate greater than 12.50% without prior approval of the institution's PSA. Growth in excess of 12.50% for two consecutive quarters may require incremental additions to capital. An institution that has regulatory capital equal to the higher of 6% or its fully phased-in capital requirement is exempt from such prior approval requirement. The minimum regulatory capital requirement in cases of mergers, consolidations, purchases of assets, assumptions of liabilities and branch acquisitions, beginning in the quarter the transaction becomes effective, would be equal to the sum of each of the institutions' combined capital requirements. While Lincoln Savings' growth has been within the 12.50% rate for the years ended December 31, 1987, 1986 and 1985, at December 31, 1987 Lincoln Savings believed it could have increased its liabilities by approximately $427 million above that rate due to its net worth position. Lincoln Savings' rate of growth in fiscal 1984, before the regulation was effective, substantially exceeded 12.5% for two consecutive quarters; for the years ended December 31, 1985 and 1986, Lincoln Savings believes that its growth was within the established limits.

The 1987 Regulations could have a significant impact on Lincoln Savings' ability to grow rapidly. By limiting the rate at which Lincoln Savings may increase its liabilities, the 1987 Regulations may affect Lincoln Savings' ability to compete with other institutions that are larger and/or are less restricted by the terms of the 1987 Regulations. Pursuant to an agreement with the FHLBB, Lincoln Savings will not seek approval to increase its liabilities in 1988 in excess of the limitations summarized above except under limited circumstances. See "—FHLBB Examination" below.

FSLIC regulations limit the aggregate amount of investments that a FSLIC-insured institution may make in real estate, equity securities, service corporations, operating subsidiaries and land loans and non-residential construction loans with the loan-to-value ratios greater than 80% (together, "equity risk investments") without prior approval of its PSA. Such regulations were recently amended to provide that institutions that (i) meet their regulatory capital requirement and have tangible capital less than 6% of total liabilities, may invest the greater of 3% of assets or 2.5 times "tangible capital," as defined, in direct investments; (ii) meet their regulatory capital requirement and have tangible capital equal to or greater than 6% of total liabilities, may invest up to three times their tangible capital in direct investments; (iii) fail to meet their minimum capital requirements shall make equity risk investments only with prior review and approval of their PSA's. Tangible capital is defined as equity capital, determined in accordance with generally accepted accounting principles, minus goodwill and other intangible assets, plus qualifying subordinated debt and qualifying non-permanent preferred stock.

Lincoln Savings has aggregate equity risk investments in excess of current limits; however, these investments were grandfathered as permissible under regulations in effect at the time they were made. Under the new regulations, Lincoln Savings is not permitted to make additional equity risk investments other than pursuant to legal commitments or definitive plans in existence on December 10, 1984. See also "—FHLBB Examination" below.

The Competitive Equality Banking Act of 1987 (the "CEBA") was signed into law on August 10, 1987. The CEBA provides for the recapitalization of the FSLIC through the creation of a financing corporation owned by the regional federal home loan banks which is authorized to issue up to $10.825 billion in debt and invest the proceeds in capital certificates or capital stock of the FSLIC; the debt will be repaid by, in effect, partially transferring the FSLIC's insurance premium assessment authority to the financing corporation. The CEBA restricts FHLB advances to a member which does not meet a qualified thrift lender test (the "QTL test"). The CEBA required the FSLIC to promulgate regulations to do the following: establish a new classification-of-assets system; establish a new appraisal standard consistent with that of the federal banking agencies; and apply Generally Accepted Accounting Principles ("GAAP") to insured institutions to the same degree it is used by the federal banking agencies. The CEBA authorizes the FSLIC to set individual capital requirements for an insured institution based on its particular financial condition; gives the FSLIC discretion to treat the failure to satisfy its minimum capital requirement as an unsafe and unsound practice; and permits the FSLIC to require an institution to adhere to a plan to increase its capital. Finally, the CEBA requires the FSLIC to establish a capital forbearance policy for well-managed failing thrifts, and permits certain accounting practices in connection with troubled debt restructurings.

On December 21 and 22, 1987 the FSLIC, pursuant to the CEBA, amended its regulations to: define a "qualified thrift lender" and modify other savings and loan holding company regulations; modify the classification-of-assets regulation and the scheduled-items regulation; revise the FSLIC's appraisal requirements; revise accounting standards for regulatory capital calculations; implement the new authority to impose individual regulatory-capital requirements; establish a capital forbearance policy for well-managed failing institutions; and clarify accounting policies for troubled debt restructurings. These amendments to the regulations are collectively referred to herein as the "CEBA Regulations."

With respect to the QTL test, the CEBA Regulations deem all insured institutions to have QTL status as of January 1, 1988. To maintain this status an insured institution must meet the 60%-of-assets test for three out of four calendar quarters and two out of three calendar years. The CEBA Regulations also define the term "related to domestic residential real estate or manufactured housing." In addition, pursuant to the CEBA, the CEBA Regulations permit "multiple" and "nonqualifying" savings and loan holding companies to engage in both "listed" and "unlisted" activities approved for bank holding companies by the Federal Reserve Board, but only with the approval of the respective PSA. At March 31, 1988, Lincoln Savings did not meet the QTL test but it expects to comply with the new requirement

in each of the next three quarters in order to meet the annual test set forth above. Therefore, Lincoln Savings does not expect this regulation to have a material effect on its financial position or results of operations.

The CEBA Regulations also amend the FSLIC's classification-of-assets regulation. The new regulation employs the previous classification categories of Substandard, Doubtful and Loss, but alters the consequences of these classifications. Assets classified "Substandard" are no longer treated as scheduled items requiring twenty percent incremental capital, and assets classified "Doubtful" do not require specific reserves; instead, examiners have more discretion to require specific reserves. The CEBA Regulations also delete the previous scheduled-items regulations entirely, and broaden the scope of the classification-of-assets regulation to include loans on the security of 1-4 family owner-occupied residences, consumer credit, and securities investments. (For purposes of regulatory capital calculations, however, each insured institution is considered to have the level of scheduled items which it had on September 30, 1987.) The amended regulation also requires insured institutions to classify their own assets and to establish prudent allowances for loan losses. See "Business—Financial Services—Classification of Assets."

The CEBA Regulations require management of an insured institution to develop written appraisal policies meeting certain minimum standards, develop guidelines for the hiring of appraisers, and review the performance of appraisers at least semiannually. Staff memorandum R-41(c) is withdrawn and replaced by a "nonbinding" policy statement providing guidance on the form and content of appraisals. The new appraisal regulation formally permits insured institutions to prepare their own appraisal policies which are different from the criteria contained in the policy statement without violating safety and soundness concerns; however, the effect of the policy statement is to provide a safe harbor for institutions whose appraisal policies are similar to those set forth in former staff memorandum R-41(c).

The CEBA Regulations substitute GAAP or bank regulatory treatment for thrift regulatory treatment with respect to a number of items in the calculation of regulatory capital. The regulation also requires all financial statements to be prepared in accordance with GAAP and to include a reconciliation of GAAP stockholders' equity capital with regulatory capital. The effective date of the regulation is January 1, 1989, with a phase-in for certain of the new standards lasting until December 31, 1993.

The CEBA Regulations also implement the authority granted by the CEBA to vary the minimum regulatory capital requirements of an insured institution as may be necessary or appropriate in light of its particular circumstances. In addition, the CEBA Regulations establish procedures implementing the FSLIC's authority to issue a directive and enforce a plan for increasing an insured institution's capital level. The CEBA Regulations also implement a capital forbearance policy for well-managed failing institutions.

The annual premium charge for FSLIC insurance is 1/12 of 1% of the insured institution's total amount of insured deposit accounts. The FSLIC can also assess additional premiums against each insured institution in any one year (up to 1/8 of 1% of the institution's total insured accounts) to meet losses and expenses of the FSLIC for that year. The FHLBB has authorized the FSLIC to impose a special quarterly premium assessment of 1/32 of 1% of each insured institution's total of insured accounts, and the FSLIC imposed the special premium assessment for each calendar quarter of 1985, 1986 and 1987.

FSLIC insurance of deposits may be terminated by the FSLIC, after notice and hearing, upon a finding by the FSLIC that an association has engaged in unsafe and unsound practices, or is in an unsafe and unsound condition to continue operations, or has violated any applicable law, regulation, rule or order or condition imposed by the FSLIC. The management of Lincoln Savings does not know of any practice, condition, or violation that might lead to termination of its deposit insurance.

Lincoln Savings believes it was in material compliance with applicable FSLIC and FHLBB regulations at December 31, 1987.

FHLBB Examination. The FHLB of San Francisco conducted a periodic examination of Lincoln Savings in 1986 and 1987 which resulted in a report of examination dated April 20, 1987 ("1986 Examination"). On May 20, 1988, Lincoln Savings and the FHLBB entered into an agreement (the "Agreement") to resolve all of the issues raised by the 1986 Examination and the negotiations concerning it between Lincoln Savings and the FHLBB. Pursuant to the Agreement, Lincoln Savings has agreed: to sell for cash, by October 1, 1988, to AMCC $10,000,000 of preferred stock that qualifies as a contribution to Lincoln Savings' regulatory capital; to make reasonable and diligent efforts to sell a minimum of $50,000,000 and a maximum of $150,000,000 in securities that qualify as contributions to Lincoln Savings' regulatory capital; to notify the FHLBB's designated agent (the "Agent") of any changes in certain reserves designated as specific for regulatory purposes; to submit to the Agent manuals describing Lincoln Savings' underwriting and operating procedures, which manuals will address certain specified policies and lending limits, and to provide prior notice to the Agent of any material modifications to such manuals; to prepare and submit to the Agent a business plan outlining Lincoln Savings' operations for the remainder of 1988 and calendar year 1989 and to provide prior notice to the Agent of any intended material modifications to the plan; until the earlier of the completion of the new examination (described below) and resolution of any issues raised thereby or December 20, 1988 (the "Interim Period"), to comply with the growth regulations of the FHLBB and not to apply for approval of a written growth plan to increase liabilities (except for any application for approval of the acquisition of another savings and loan institution or the opening of additional branch offices); during the Interim Period, not to increase the dollar amount of its aggregate equity risk investments or to increase the dollar amount of its investment in real estate (except for capitalization of costs and expenses incurred which are reasonable and necessary to develop existing real estate projects) (this restriction on equity risk investments will permit Lincoln Savings' service corporations to continue to reinvest current assets in equity risk investments other than real estate); to add a "contingency factor" in the calculation of Lincoln Savings' regulatory capital requirement equal to ten percent of Lincoln Savings' equity risk investments in excess of $550,000,000 (this increase is in lieu of any incremental increase in Lincoln Savings' capital requirement which might otherwise have been necessitated by Lincoln Savings' aggregate equity risk investments); and, during the Interim Period, not to pay any dividends unless it notifies the Agent at least two weeks prior to the proposed payment, and the Agent does not object. Of existing reserves recorded at December 31, 1987, Lincoln Savings has designated as specific for regulatory purposes $18,269,000 related to assets questioned in the 1986 Examination.

During the Interim Period, Lincoln Savings expects to file an application for a waiver to allow it to maintain equity risk investments in an amount up to one-third of its total consolidated assets; the FHLBB will act on such application in conjunction with the resolution of the new examination. The new examination is expected to commence in June 1988, with a report of examination and the resolution of any issues arising therefrom to be completed by December 20, 1988. This will be a regular, periodic FHLBB examination which will be conducted, under the direction of the Washington D.C. Office of Regulatory Policy, Oversight and Supervision ("ORPOS"), by an examination team with no examiners from the FHLB of San Francisco. During the course of the new examination, Lincoln Savings expects to identify another savings and loan institution which it proposes to acquire in a FHLB District other than San Francisco. When the new examination is resolved, Lincoln Savings will submit an application to the FHLBB to move its headquarters to the district in which it proposes to acquire a savings and loan. If such application is approved by FSLIC and the FHLBB, all supervisory and examination authority over Lincoln Savings will be transferred to the FHLB for the new district. ORPOS currently has exclusive supervisory and examination authority over Lincoln Savings and will act as Lincoln Savings' Principal Supervisory Agent.

Federal Reserve System

Federal Reserve Board regulations require savings and loan associations to maintain reserves against their transaction accounts and non-personal time deposits. The regulations generally require

that reserves of 3% be maintained against transaction accounts up to $40.5 million and a reserve of 12% (subject to adjustment by the Federal Reserve Board between 8% and 14%) against that portion of aggregate transaction accounts in excess of such amount. In addition, a reserve of 3% must be maintained on non-personal time deposits which have maturities of less than one and one-half years. Thrift institutions may designate and exempt $2.4 million (subject to annual adjustment by the Federal Reserve Board) of reservable liabilities, which are defined to include transaction accounts and non-personal time deposits from either of these reserve requirement levels.

The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements that may be imposed by the FHLBB. The effect of this reserve requirement has been and will be to increase Lincoln Savings' cost of funds. Savings and loan associations have authority to borrow from the Federal Reserve Board "discount window," but Federal Reserve Board regulations require them to exhaust all FHLBB System sources before doing so.

Lincoln Savings believes it was in material compliance with applicable Federal Reserve Board regulations at December 31, 1987.

Recent Regulatory Developments

The reserves of the FSLIC have been severely depleted, as a result of the failure of a large number of savings institutions over the past few years, to a level generally considered to be inadequate. The U.S. General Accounting Office has reported that, taking into account anticipated losses to be borne by the FSLIC, the FSLIC insurance fund's liabilities exceed its assets. The U.S. Congress, the Administration and industry groups have discussed various methods of dealing with this situation, including the merger of the FSLIC and the Federal Deposit Insurance Corporation. The proposals receiving most active consideration by Congress, however, would involve recapitalization of the FSLIC insurance fund, with the funding for such recapitalization to be derived from public debt issuances by a specially created corporation to be capitalized with funds from the FHLB System, and regular and special FSLIC insurance premiums to be assessed against all FSLIC-insured institutions. While no reliable prediction can be made as to whether any of such proposals will be adopted, it is generally anticipated that the adoption of a recapitalization plan for the FSLIC would result in the continuation of increased FSLIC insurance premium expense for member institutions. Such adoption could also have the effect of increasing the cost of FHLB advances to member institutions and/or reducing the level of dividends received by member institutions on their FHLB stock.

SEC Investigation

Pursuant to a formal order of investigation entered by the Securities and Exchange Commission in December 1987, the Commission has subpoenaed documents relating principally to issues raised in the 1986 Examination report, although the SEC's investigation is not limited to the time period covered by the FHLBB examination. The Commission's staff has stated that the inquiry "should not be construed as an indication by the Commission or its staff that any violation of law has occurred nor should it be considered a reflection upon any person, entity or security."

Insurance Company Regulation

AFL and CFLIC are organized under the laws of the states of Texas and Arizona, respectively, and are subject to the comprehensive regulation, examination, supervision and reporting requirements of the insurance department of those states. Among other things, the regulations govern the types of investments, products, advertisements, premiums, and claims practices of the insurers. AFL and CFLIC are also subject to the insurance regulations of each of the other states in which they conduct business. AFL engages in business in 35 states and the District of Columbia, in addition to Texas, and CFLIC engages in business in New Mexico in addition to Arizona.

Insurance West is licensed as an insurance agent in 14 states and is subject to the insurance regulations of each of those states.

REAL ESTATE ACTIVITIES

The Company's real estate activities, located principally in Arizona, Colorado, Georgia and Texas, consist of land development and investment and the development, management, syndication and sale of commercial and income-producing properties. During 1987, real estate activities contributed $236,960,000 in revenues and $3,589,000 of pre-tax earnings, representing 33% of the revenues and 14% of the pre-tax earnings for the Company.

Land Development and Investment

The Company's revenues and gross profit from real estate sales were $220,924,000 and $81,560,000, respectively, in 1987 and $296,039,000 and $79,882,000, respectively, in 1986.

The Company currently controls large tracts of land within the projected growth patterns of several of the nation's fastest growing metropolitan areas of Arizona, Colorado, Georgia, and Texas. The Company believes that investment in "growth corridor" locations helps to reduce the holding period risk normally associated with large scale land purchases. The Company generally targets acreage for investment, whether by direct ownership or indirectly through lending and joint venture relationships, which offers potential for profitable development within a two-year time frame.

The Company engages in a value-added approach to land investment by its direct participation in the design, annexation, zoning, development and marketing processes. The Company is actively engaged in the development of the real property owned by it, and currently does not intend to significantly increase its aggregate real estate investments. Lincoln Savings has undertaken not to make any additional land investments pending completion of the 1986 FHLBB examination process. See "Business—Regulation—Federal Home Loan Bank."

In 1983, the Company commenced a program to acquire acreage which offers potential for profitable development of mixed-use planned communities. The following table summarizes the significant planned communities currently in the planning, development or completion stage:

Project(1)	Location	Book Value at December 31, 1987 (Dollars in thousands)
Islands	Gilbert, Arizona	$ 6,126
The Uplands	Austin, Texas	88,157
Lakewood	Phoenix, Arizona	7,390
Continental Ranch	Tucson, Arizona	32,067
Andersen Springs	Chandler, Arizona	8,265
Garden Lakes	Avondale, Arizona	20,310
Estrella	Goodyear, Arizona	76,006
The Meadows	Castle Rock, Colorado	44,380
St. Tammany Highlands	New Orleans, Louisiana	19,320
Continental Southern	Atlanta, Georgia	62,998

(1) All of the projects are being developed by Lincoln Savings or its subsidiaries.

Sales and gross profits in the Company's master planned communities totalled $111,680,000 and $66,110,000, respectively, in 1987, $103,402,000 and $27,785,000, respectively, in 1986 and $78,720,000 and $28,028,000, respectively, in 1985.

Commercial Development

The Company's commercial properties are designed and developed or acquired by American Continental Properties, Inc. ("ACP"), a subsidiary of the Company, and The Crescent Hotel Group

("Crescent"), a subsidiary of Lincoln Savings which commenced operations in 1984. The Company's commercial development activities produced revenues and gross profit of $4,011,000 and $2,943,000, respectively, in 1987 and $48,973,000 and $6,001,000, respectively, in 1986.

Commercial Properties. ACP concentrates on the development, management, syndication and sale of commercial and income-producing properties. During 1987, retail centers, hotels (in conjunction with Crescent), and industrial parks emerged as significant projects, while apartment and office developments became a smaller percentage of ACP's total portfolio.

The following table summarizes ACP's retail shopping centers completed or under development:

Center	Location	Rentable Square Feet
Continental Plaza	Mesa, Arizona	48,000
McClintock Fountains	Tempe, Arizona	140,500
Union Square	Phoenix, Arizona	76,000
Fountain Square	Phoenix, Arizona	122,000
		386,500

Hotels. The Crescent Hotel Group ("Crescent") was formed in 1984 to acquire existing hotel properties and to develop new hotels. In December 1984, Crescent acquired The Pontchartrain Hotel in Detroit, Michigan. The Pontchartrain is a 420-unit luxury hotel located in the downtown business district near the Renaissance Center. Crescent sold The Pontchartrain for $38,400,000 to a group of investors, including certain of the Company's officers and directors (with an aggregate ownership interest of 28%), resulting in a gross profit of approximately $9,505,000. Crescent completed substantial renovations to The Pontchartrain in February 1986. At December 31, 1987, Crescent Lending Corporation, a subsidiary of the Company, had loaned $15,093,000 to the partnership under a $20,000,000 line of credit. Such line of credit has been used to fund cash flow deficits of the partnership since inception.

In 1984, Crescent acquired The Phoenician Resort, an 18-hole golf course and 35 acres of land with hotel zoning, for approximately $21,000,000. Crescent is constructing a luxury destination resort with 474 rooms, 132 casitas, meeting rooms, tennis courts and other amenities. At December 31, 1987, the estimated costs to complete the Resort were $109,000,000. The property is situated on Camelback Road, adjacent to Scottsdale's business district and the "Camelback Corridor" of Phoenix, with easy airport access. Construction of The Phoenician was commenced in 1986 and is anticipated to be completed in Fall 1988. In early 1987, Crescent completed construction of, and began operating, an executive business travelers' hotel, The Crescent Hotel of Phoenix, with 348 rooms and conference, dining and athletic facilities in Phoenix, Arizona. Crescent has no other hotels planned at this time.

In June 1987, the Company sold for cash a 45% interest in the Crescent Hotel of Phoenix and The Phoenician Resort to an unrelated party. Proceeds from the sale totaled $173,650,000, which included $74,486,000 of funds placed in escrow for the development of The Phoenician Resort. The Company has recorded a $12,880,000 gain on the sale; $1,570,000 of the gain is deferred and will be recognized as The Phoenician Resort is completed.

Disposition of Property. The decision whether to sell outright or syndicate a property depends on a variety of factors, including the sales terms, availability of financing and the ability to obtain investors. The success of future syndications may depend on changes in federal income tax laws which have restricted such syndications.

PROPERTIES

The Company's principal offices are located in Phoenix, Arizona. Lincoln Savings operates, through its principal office in Irvine, California, 29 branch offices located in Southern California, an

agency office in Phoenix, Arizona, and an agency office for origination of residential construction loans in San Diego, California.

Branch Offices

Lincoln Savings operates 29 branch offices throughout Los Angeles, Riverside, Ventura, San Diego and Orange Counties. These offices are located in areas which are easily accessible to the public in such facilities as shopping malls and single and multiple-story office buildings on major streets. Of the total branch sites, Lincoln Savings owns five, one of which was encumbered at December 31, 1987. Substantially all others are leased with multiple options to renew the leases in such a manner as to ensure stability throughout the branch network. The locations of the branch offices and, where applicable, their lease expiration dates and number of years over which the leases can be renewed, are as follows:

Branches Owned by Lincoln Savings

300 E. Main Street
Alhambra, California 91801

200 E. Duarte Road
Arcadia, California 91006

17851 Chatsworth Street
Granada Hills, California 91344

29920 Hawthorne Boulevard
Rolling Hills Estates, California 90274

1631 N. Bristol Street
Santa Ana, California 92706

Branches Leased by Lincoln Savings	Date Lease Expires	Additional Years Covered By Renewal Options
5791 Santa Ana Canyon Road Anaheim Hills, California 92807	September 12, 1995	5
3800 W. Verdugo Avenue Burbank, California 91505	February 28, 2006	None
2300 Ponderosa Camarillo, California 93010	August 31, 2000	10
1810 Marron Road Carlsbad, California 92008	March 31, 2012	9
10033 Paramount Boulevard Downey, California 90240	November 14, 1989	None(1)
1655 East Valley Parkway Escondido, California 92027	October 31, 1993	10
100 E. Glenoaks Boulevard Glendale, California 91207	September 30, 1998	20
1111 S. State Street Hemet, California 92343	September 30, 2003	20
7050 Hollywood Boulevard Hollywood, California 90028	April 30, 1991	30
7662 Edinger Huntington Beach, California 92647	October 31, 2015	None
Koll Center 18200 Von Karman Avenue Irvine, California 92715	August 31, 1994	10
3978 Barranca Parkway Irvine, California 92714	January 31, 1998	15

(1) A new Downey branch facility is currently under construction, with a scheduled completion date of third quarter 1988.

Branches Leased by Lincoln Savings	Date Lease Expires	Additional Years Covered By Renewal Options
23601 Moulton Parkway Laguna Hills, California 92653	December 31, 2001	40
5247 Hazelbrook Avenue, #4 Lakewood Shopping Center Lakewood, California 90712	January 31, 1995	None
11285 National Boulevard Los Angeles, California 90064	October 31, 1999	10
630 W. Sixth Street Los Angeles, California 90017	January 31, 1989	23
14526 Roscoe Boulevard Panorama City, California 91402	March 14, 1995	10
16471 Bernardo Center Drive Rancho Bernardo, California 92128	July 31, 2002	None
1460 Fourth Street Santa Monica, California 90401	August 13, 2005	20
13701 Riverside Drive Sherman Oaks, California 91403	December 31, 1988	85
28127 Bradley Road Sun City, California 92381	November 30, 2001	10
21835 Hawthorne Boulevard Torrance, California 90503	August 13, 2001	20
13031 Newport Avenue, Suite 115 Tustin, California 92680	August 26, 1996	10
5995 Topanga Canyon Boulevard Woodland Hills, California 91367	June 30, 1995	10

EMPLOYEES

The Company employed approximately 1,790 full-time and part-time persons at December 31, 1987, of which approximately 477 persons were employed in connection with real estate operations. There are no unions or collective bargaining units representing employees. Employee relations are satisfactory. The Company provides its employees with various benefits, including a retirement plan and life, health, dental and accident insurance programs.

LEGAL PROCEEDINGS

The Company is involved in a number of lawsuits incidental to its business. The Company believes that such proceedings, in the aggregate, will not have a material effect on the Company's financial position or operating results.

DESCRIPTION OF DEBENTURES

Each series of Debentures will be issued pursuant to an Indenture (the "Indenture") dated as of October 1, 1986, between the Company and The First National Bank of Cincinnati as Trustee (the "Trustee"), as supplemented from time to time to establish the respective series of Debentures or as otherwise amended. The Company intends to offer the Debentures for sale directly to the public from time to time pursuant to this Prospectus. Based upon market conditions, the Company periodically will establish series of Debentures conforming to the description of the Debentures set forth in this Prospectus and any prospectus supplemental hereto. Sales of a series of Debentures may not be consummated unless and until this Prospectus has been supplemented by a Prospectus Supplement with respect to such series that sets forth (i) the maximum aggregate principal amount, interest rate and maturity date of the Debentures of such series and (ii) the redemption and certain repayment upon death provisions with respect to such series.

A copy of the Indenture and each supplement and amendment thereto have been or will be filed as an exhibit to the Registration Statement of which this Prospectus forms a part or incorporated by reference into this Prospectus or filed as an exhibit to a Current Report on Form 8-K filed by the Company under §13(a) of the Exchange Act. The following summaries of certain provisions of the Indenture do not purport to be complete and are subject to, and are qualified in their entirety by reference to, all of the provisions of the Indenture and each supplement and amendment thereto, including the definitions therein of certain capitalized terms, which provisions and definitions are incorporated herein by reference. All references to a "Section" or an "Article" herein are to the applicable Section or Article of the Indenture.

General

The Debentures are issuable in series. An unlimited principal amount of Debentures may be issued pursuant to the Indenture, with such terms, not inconsistent with the Indenture, as the Company may determine. Each series of Debentures will mature on such date, will bear interest at such rate and will have such other terms as the Company may determine from time to time.

The Debentures will be unsecured obligations of the Company and will not have the benefit of a sinking fund for the retirement of principal. Principal (and premium, if any) and interest will be payable at an office or agency that the Company will maintain in Irvine, California or Phoenix, Arizona except that, at its option, the Company may pay interest by check mailed directly to the address of the person entitled thereto as it appears on the Debenture Register. (Section 2.04).

The Company will issue the Debentures only in fully registered form, without coupons, in minimum denominations of $1,000 and any amount in excess thereof in increments of $1,000, unless any other amounts should be established in the supplemental indenture authorizing a series. (Section 2.02). The Company will not assess a service charge for any transfer or exchange of the Debentures, but the Company may require payment of a sum sufficient to cover any tax or governmental charge payable in connection therewith. Holders may transfer the Debentures by surrendering them for transfer at the office of the Registrar. (Section 2.07).

Payment of Interest

Each series of Debentures will bear interest at the rate specified in the Prospectus Supplement with respect to such series. Unless otherwise stated in a Prospectus Supplement, interest shall be payable monthly, on the 28th day of each month, with respect to interest accrued through the last day of the preceding month except that all interest accrued to a payment date shall be paid when the principal of the Debenture is paid. The first interest payment date with respect to each individual Debenture will be the 28th day of the month next following the month in which such Debenture was originally purchased from the Company, and such interest payment will include interest accrued from the date the purchase

price for such Debenture is received by the Company through the last day of such month of issuance. Interest will be paid to the persons in whose names the Debentures are registered in the Debenture Register at the close of business on the last day of the month preceding the month in which the interest payment occurs. Interest will be calculated on the basis of a 360-day year with twelve 30-day months. (Section 2.02).

Until maturity or redemption, interest that accrues monthly on the Debentures is payable in arrears on the 28th day of the following month, thereby reducing the effective yield to holders of the Debentures.

Redemption at the Option of the Company

The Debentures are subject to redemption at the option of the Company, in whole at any time or in part from time to time, commencing on the date and at the redemption prices specified in the Prospectus Supplement for each series of Debentures. The Debentures may be redeemed upon not less than 30 nor more than 60 days' notice mailed to the registered holders thereof. If the Company elects to redeem less than all of the Debentures, the Trustee will select which Debentures to redeem, using such method as it shall deem fair and appropriate.

Limited Right of Payment upon Death

The Company, upon the death of any holder of Debentures, will repay such holder's Debentures on request if (a) the Debentures have been registered in the holder's name since the date of issue or for a period of at least six months prior to the date of the holder's death, whichever is less, (b) the principal amount of the Debentures of all series considered together to be repaid as a result of the deceased holder's death does not exceed $50,000, (c) the principal amount of the Debentures of each series considered individually to be repaid as a result of the deceased holder's death does not exceed $25,000 (unless a greater amount, not to exceed $50,000, was specified in the supplemental indenture authorizing such series) and (d) either the Company or the Trustee has been notified in writing of the request for repayment within 180 days after the death. Debentures for which such repayment is requested shall be repaid at 100% of the principal amount thereof, together with interest accrued to the Repayment Date, within 30 days following receipt by the Company or the Trustee of the following: (i) a written request for repayment signed by a duly authorized representative of the holder, which shall indicate the name of the deceased holder, the date of his death and the principal amount of Debentures to be repaid, (ii) the certificates representing the Debentures to be repaid, (iii) evidence satisfactory to the Company and the Trustee of the death of the holder and evidence of the authority of the representative to the extent required by the Trustee. Authorized representatives of a holder shall include executors, administrators or other legal representatives of an estate, trustees of a trust, joint owners of Debentures owned in joint tenancy or in tenancy by the entirety, custodians, conservators, guardians, attorneys-in-fact and other persons generally recognized as having legal authority to act on behalf of another. (Article 4).

The death of a person owning a Debenture in joint tenancy or tenancy by the entirety with another or others shall be deemed the death of the holder of the Debenture, and the entire principal amount of the Debenture so held shall be subject to repayment, together with interest accrued thereon to the Repayment Date. The death of a person owning a Debenture by tenancy in common shall be deemed the death of a holder of a Debenture only with respect to the deceased holder's interest in the Debenture so held by tenancy in common; except that in the event a Debenture is held by husband and wife as tenants in common, the death of either shall be deemed the death of the holder of the Debenture, and the entire principal amount of the Debenture so held shall be subject to repayment, together with interest accrued thereon to the Repayment Date. The death of a person who, during his lifetime, was entitled to substantially all of the beneficial interests of ownership of a Debenture, will be deemed the holder thereof for purposes of this provision, regardless of the registered holder, if such beneficial interest can be established to the satisfaction of the Trustee. Such beneficial interest will be deemed to exist in typical cases of street name or nominee ownership, ownership under the Uniform Gifts to

Minors Act, community property or other joint ownership arrangements between a husband and wife, and trust and certain other arrangements where one person has substantially all of the beneficial ownership interests in the Debenture during his lifetime. Beneficial interest shall include the power to sell, transfer or otherwise dispose of a Debenture and the right to receive the proceeds therefrom, as well as interest and principal payable with respect thereto. (Article 4).

Subordination

Payment of the principal of (and premium, if any) and interest on the Debentures shall be subordinated and subject to the prior payment in full of all Senior Indebtedness so that (a) upon any distribution or other marshalling of the assets of the Company, whether upon dissolution, liquidation, reorganization or receivership proceedings or otherwise, no payment may be made in respect of the Debentures until all Senior Indebtedness shall have been paid in full or duly provided for, (b) upon maturity of any Senior Indebtedness by lapse of time, acceleration, or otherwise, all amounts payable in respect of such Senior Indebtedness shall be paid in full or duly provided for before any payments may be made on the Debentures, and (c) upon the happening of an event of default with respect to any Senior Indebtedness permitting the holders thereof to accelerate the maturity thereof, no payment shall be made with respect to the principal of (or premium, if any) or interest on the Debentures unless and until such event of default shall have been cured or waived. (Article 3).

The Indenture defines Senior Indebtedness to mean principal of and interest on (including, but not limited to, interest accruing after the commencement of a proceeding arising under any Bankruptcy Law) (i) any liability of the Company whether outstanding on the date hereof or hereafter created (a) for money borrowed, or (b) evidenced by notes, bonds or debentures or similar instruments (other than the Debentures), or (c) in connection with the acquisition of a business, real property or other assets (except inventory or similar property acquired in the course of ordinary conduct of the acquiror's usual business), or (d) for the payment of money relating to capitalized lease obligations, or (ii) any liability of others described in the preceding clause (i) which is guaranteed or assumed, directly or indirectly (whether by guaranty, endorsement or otherwise, by the Company) and (iii) all renewals, extensions, refundings and other modifications of any such indebtedness. Notwithstanding anything to the contrary in the Indenture or the Debentures, "Senior Indebtedness" shall not include any indebtedness which, by its terms or the terms of the instrument creating or evidencing it, provides that (i) such indebtedness is not senior in right of payment to the payment of principal of and interest on the Debentures, (ii) such indebtedness is not *pari passu* in right of payment with all other Senior Indebtedness or is junior in right of payment to Senior Indebtedness but is expressly senior in right of payment to Subordinated Indebtedness or (iii) such indebtedness is subordinate in right of payment to or *pari passu* with the Debentures. For purposes of this definition, the term "Bankruptcy Law" means title 11 of the U.S. Code or any similar Federal or state law for the relief of debtors. (Section 3.02). "Senior Indebtedness" specifically includes the Company's 14¼% Senior Subordinated Notes due April 15, 1995 and any indebtedness which is *pari passu* or senior in right of payment with such Senior Subordinated Notes. Senior Indebtedness was approximately $150,134,000 at December 31, 1987.

The Debentures will be senior to the Company's Common Stock and any other class of capital stock that the Company may authorize or issue. The rights of the Company and its creditors to participate in the assets of any of the Company's subsidiaries upon liquidation or reorganization of a subsidiary are subject to the prior claims of the subsidiary's creditors. By reason of the subordination provisions, in the event of bankruptcy or insolvency, creditors of the Company who are not holders of Senior Indebtedness, including the Debentureholders, may recover less, ratably, than the holders of the Senior Indebtedness.

Successor Corporation

The Company may not consolidate with, merge into or transfer all or substantially all of its assets to another corporation unless (i) such corporation is organized under the laws of the United States or

any state thereof or the District of Columbia; (ii) such corporation assumes by supplemental indenture all the obligations of the Company under the Debentures and the Indenture; and (iii) immediately after such transaction, no Default exists. (Section 6.01).

Events of Default

The Indenture defines the following as "Events of Default" with respect to any series of Debentures: (a) failure to pay interest on any Debenture of such series for 30 days after becoming due, (b) failure to pay principal (or premium, if any) with respect to any Debenture of such series when due at maturity, upon redemption, or by declaration, as provided in the Indenture, (c) failure to perform any other covenant for 60 days after written notice specifying the default and requiring the Company to remedy such default, and (d) certain events of insolvency or reorganization. (Section 7.01).

The Indenture provides that the Trustee, within 90 days after the occurrence of a default, shall give the Holders of the Debentures notice of all uncured defaults known to it (the term "default" means the above specified events without grace periods); provided, that, except in the case of default in the payment of principal (or premium, if any) or interest, the Trustee shall be protected in withholding such notice if and so long as it in good faith determines that the withholding of such notice is in the interest of the Holders of the Debentures. (Section 8.05).

If an Event of Default shall occur and be continuing with respect to any series of Debentures, the Trustee, in its discretion, may, and at the written request of Holders of a majority in aggregate principal amount of the outstanding Debentures of the series (or, of all the outstanding Debentures in the case of Events of Default specified in clauses (c) and (d)) and, upon being indemnified to its satisfaction, shall proceed to protect and enforce its rights and the rights of the Holders of the affected Debentures. If an Event of Default shall occur and be continuing, either the Trustee or the Holders of at least 25% in aggregate principal amount of outstanding Debentures of the series (or, of all the outstanding Debentures in the case of Events of Default specified in clauses (c) and (d)) may accelerate the maturity of such series (or of all outstanding Debentures, as the case may be). Any Event of Default with respect to a particular series of Debentures may be waived by the Holders of a majority in aggregate principal amount of the outstanding Debentures of such series (or of all the outstanding Debentures, as the case may be), except in each case a failure to pay principal or premium, if any, or interest on such Debenture. (Sections 7.02, 7.03 and 7.04).

Modification and Satisfaction of Indenture

With certain exceptions that permit modification of the Indenture by the Company only, the Indenture, the rights and obligations of the Company and the rights of the Holders of the Debentures may be modified by the Company with the consent of Holders of not less than a majority in aggregate principal amount of the outstanding Debentures of all series issued under the Indenture which are affected by the modification (voting as one class); provided that the Company may make no such modification without the consent of the Holder of each Debenture affected thereby if such modification would (a) change the stated maturity date of the principal of, or any installment of interest on, any such Debenture; (b) reduce the principal of (or premium, if any) or interest on any such Debenture; (c) change the currency of payment of principal of (or premium, if any) or interest on any such Debenture; (d) impair the right to institute suit for the enforcement of any payment on or with respect to any such Debenture; (e) reduce the above stated percentage of Holders of outstanding Debentures necessary to modify the Indenture; (f) modify the foregoing requirements or reduce the percentage of any such Debentures necessary to waive any past default; (g) subordinate the Debentures to any indebtedness of the Company other than Senior Indebtedness or (h) impair the right to request payment of any such Debentures upon events described under "Limited Right of Repayment upon Death" above. (Sections 10.01 and 10.02).

Upon cancellation of all the Debentures of a series, or, with certain limitations, upon the Company's deposit with the Trustee of funds (or U.S. government obligations) sufficient therefor, the Company may satisfy and discharge the Indenture with respect to such series. (Section 9.01).

Limited Marketability

The Company is not required to sell any minimum aggregate principal amount of Debentures or of any series of Debentures. It is unlikely that a market for the Debentures will exist after the offering, and any secondary market which might develop will very limited. The Debentures will not be listed on any securities exchange or on NASDAQ. If less than all of the Debentures are sold, any such market may be even more limited. The issuance of the Debentures in series, each of limited aggregate principal amount, further inhibits the development of a market. For these reasons, it will be difficult to resell the Debentures and Holders shall not expect the Company to repurchase the Debentures.

Reports to Debentureholders

The Company will furnish to Debentureholders annual reports containing certified financial statements of the Company.

Concerning the Trustee; Paying Agent and Registrar

The First National Bank of Cincinnati is the Trustee under the Indenture.

The Indenture contains certain limitations on the right of the Trustee, should it become a creditor of the Company, to obtain payment of claims in certain cases, or to realize on certain property received in respect of any such claim as security or otherwise. The Trustee will be permitted to engage in other transactions; however, if it acquires any conflicting interest it must eliminate such conflict or resign. (Sections 8.10 and 8.11).

The holders of a majority in principal amount of all outstanding Debentures will have the right to direct the time, method and place of conducting any proceeding for exercising any remedy available to the Trustee, provided that such direction would not conflict with any rule of law or with the Indenture, would not be unduly prejudicial to the rights of another Debentureholder, or would not involve the Trustee in personal liability. (Section 7.05). The Indenture provides that, in case a Default shall occur and is continuing, the Trustee will be required in the exercise of its powers to use the degree of care and skill of a prudent man in the conduct of his own affairs. Subject to such provisions, the Trustee will be under no obligation to exercise any of its rights or powers under the Indenture at the request of any of the Debentureholders, unless they shall have offered to the Trustee indemnity satisfactory to it. (Section 8.01).

All payments of principal of and interest on, and registration, transfer, exchange, delivery (including delivery on original issuance of the Debentures) and redemption of, the Debentures will be effected initially by the Company as Paying Agent and Registrar.

Tax Consequences to Debentureholders

Payments received by holders of the Debentures are accorded the same tax treatment under the Internal Revenue Code of 1986, as amended, as payments received on other taxable corporate bonds. In general, interest accrued and paid upon the unpaid principal balance of the Debentures from time to time, and original issue discount, if any, should be taxed as ordinary income. Principal payments made on the Debentures should, to the extent of a Debentureholder's basis in the Debentures, be treated as a return of capital. Under the Internal Revenue Code of 1986, as amended, 30% (or if applicable, the lower tax treaty rate) of all interest payments made to Debentureholders who are non-resident aliens or foreign corporations, or other foreign persons, currently are subject to withholding requirements unless such interest is effectively connected with the conduct of a trade or business in the United States.

PLAN OF DISTRIBUTION

The Debentures will be offered for sale at branches of Lincoln Savings and Loan Association, by persons who are full-time employees of the Company or an affiliate of the Company (other than Lincoln Savings) and, subject to the receipt of certain state regulatory approvals, at the offices of the Company in Phoenix, Arizona. In addition, subject to the receipt of applicable state regulatory approvals, the Company may send notice of the offering of any series of Debentures, or a copy of this Prospectus and the supplemental prospectus relating to such series, to holders of other securities of the Company and its subsidiaries in the states where such holders reside. No person involved in the sale of the Debentures will be compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities. Any such person will primarily perform, or will be intended primarily to perform at the end of the offering, substantial duties for or on behalf of the Company otherwise than in connection with transactions in securities, and will not have been a broker or dealer, or an associated person of a broker or dealer, within the preceding 12 months. The activities of the persons involved in the offering will otherwise comply with the provisions of the Regulation 3a4-1 promulgated under the Securities Exchange Act of 1934, as amended, which sets forth the conditions under which an associated person of an issuer of securities will not be deemed to be a broker solely by reason of his participation in the sale of the securities of such issuer.

LEGAL MATTERS

The legality of the Debentures offered hereby will be passed upon for the Company by Kaye, Scholer, Fierman, Hays & Handler, 425 Park Avenue, New York, New York 10022. Certain legal matters in connection with the offering will be passed upon for the Company by Parker, Milliken, Clark, O'Hara & Samuelian, 333 South Hope Street, Los Angeles, California.

EXPERTS

The financial statements of American Continental Corporation included in the Company's Annual Report to Shareholders for the year ended December 31, 1987 have been examined by Arthur Young & Company, independent public accountants, at December 31, 1987 and 1986 and for the years then ended and by Arthur Andersen & Co., independent public accountants, at December 31, 1985 and for the year then ended, as set forth in their respective reports included therein and incorporated herein by reference. The financial statements referred to above are incorporated herein by reference in reliance upon such reports and upon the authority of said firms as experts in auditing and accounting.

No dealer, salesman or any other person has been authorized to give any information or to make any representations in connection with this offering other than those contained in this Prospectus and any Prospectus Supplement, and if given or made, such information or representations must not be relied upon as having been authorized by the Company. This Prospectus does not constitute an offer to sell or a solicitation of an offer to buy any of these securities in any state to any person to whom it is unlawful to make such offer or solicitation in such state. The delivery of this Prospectus or any Prospectus Supplement shall not under any circumstances, create any implication that there has been no change in the affairs of the Company since the date hereof or thereof.

TABLE OF CONTENTS

American Continental Corporation

$300,000,000
Subordinate Debentures

PROSPECTUS

June 6, 1988

PROSPECTUS SUPPLEMENT
(to Prospectus dated June 26, 1987)

$20,000,000
American Continental Corporation
9½% Subordinate Debentures
Series G-2
Due January 1, 1989

American Continental Corporation (the "Company") is offering directly to the public up to $20,000,000 aggregate principal amount of its 9½% Subordinate Debentures, Series G-2, due January 1, 1989 (the "Series G-2 Debentures").

Each Series G-2 Debenture will bear interest from its date of issue (the date on which payment of the purchase price for such Series G-2 Debenture is received by the Company) at the rate of 9½% per annum, payable monthly on the 28th day of each month, commencing with the 28th day of the calendar month following the month in which such Series G-2 Debenture is purchased from the Company.

The Series G-2 Debentures will be redeemable at the option of the Company, in whole or in part, commencing July 1, 1988 at a redemption price equal to 100% of principal amount together with accrued interest.

See "Description of Debentures—Redemption at the Option of the Company" in the Prospectus.

The Series G-2 Debentures will be subordinated to the Company's Senior Indebtedness (as defined in the Indenture), which was approximately $252,350,000 at December 31, 1986, and will rank pari passu with Subordinated Indebtedness of the Company (as defined in the Indenture), which was approximately $2,496,000 at December 31, 1986. The Indenture under which the Series G-2 Debentures are to be issued does not limit the amount of Senior Indebtedness the Company may incur. The Series G-2 Debentures will be sold in minimum denominations of $1,000. See "Description of Debentures" in the Prospectus.

Subject to the receipt of applicable state regulatory approvals, the Company may send notice of the offering of one or more series of the Subordinate Debentures, or a copy of the Prospectus and the Prospectus Supplement(s) relating to such series, to holders of other securities of the Company and its subsidiaries in the states where such holders reside. See "Plan of Distribution" in the Prospectus.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

THE DEBENTURES BEING OFFERED ARE THE SOLE OBLIGATION OF THE COMPANY AND ARE NOT BEING OFFERED AS SAVINGS ACCOUNTS OR DEPOSITS AND ARE NOT INSURED BY THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION.

	Price to Public	Underwriting Discount	Proceeds to Company(2)
Per Debenture	100%	-0-	100%
Maximum Total Series G-2 Debentures(1)	$20,000,000	-0-	$20,000,000

(1) There is no minimum amount of Series G-2 Debentures required to be sold by the Company.
(2) Before deducting expenses payable by the Company in connection with the Series G-2 Debentures, estimated to be $25,000.

This Prospectus Supplement does not contain complete information about the offering of the Series G-2 Debentures. Additional information is contained in the Prospectus and purchasers are urged to read both the Prospectus and the Prospectus Supplement in full. **Sales of the Series G-2 Debentures may not be consummated unless the purchaser has received both the Prospectus and this Prospectus Supplement.** The Series G-2 Debentures constitutes a separate series of $200,000,000 authorized issue of Subordinate Debentures expected to be offered from time to time by the Company.

The date of this Prospectus Supplement is November 30, 1987.

No dealer, salesman or any other person has been authorized to give any information or to make any representations other than those contained in this Prospectus Supplement and the accompanying Prospectus and, if given or made, such representations must not be relied upon as having been authorized by the Company. This Prospectus Supplement and the accompanying Prospectus do not constitute an offer or solicitation by anyone in any state in which such offer or solicitation is not authorized or in which the person making such offer or solicitation is not qualified to do so, or to any person to whom it is unlawful to make such offer or solicitation. Neither the delivery of this Prospectus Supplement and the accompanying Prospectus nor any sales made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Company since the date of the Prospectus Supplement.

American Continental Corporation

$20,000,000

9½% Subordinate Debentures

Series G-2

Due January 1, 1989

PROSPECTUS SUPPLEMENT

November 30, 1987

EXHIBIT E

PURCHASE AGREEMENT

AMERICAN CONTINENTAL CORPORATION
SUBORDINATE DEBENTURES
SERIES A-4

Principal Amount:	$75,000.00
Interest Rate:	12.000%
Date of Purchase:	JANUARY 20, 1988
Due Date:	FEBRUARY 1, 1993
Ref No:	[redacted]

By signing this Purchase Agreement, the undersigned ("Purchaser") hereby purchases the Subordinate Debentures of American Continental Corporation in the Series and amount, and with the interest rate and maturity shown above. Purchaser acknowledges receipt of the Prospectus and Prospectus Supplement relating to the Subordinate Debentures and the latest Annual Report and Form 10-Q of American Continental Corporation and authorizes payment of interest pursuant to instructions given below.

Debentures to be Registered in Name(s) of:

[redacted]

Tax ID No.: 155-22-9608

Payment of Interest:

[redacted]

X [redacted]
Signature of Purchaser
714 997-3619

Signature of Purchaser

ACCEPTANCE OF PURCHASE

American Continental Corporation accepts the Purchase of the Principal Amount of Debentures shown hereon.

American Continental Corporation

Don Grier
Authorized Representative
714 730-0245

RECEIPT

AMERICAN CONTINENTAL CORPORATION Phoenix, Az

SUBORDINATE DEBENTURE SERIES A-4
AT 12.000% DUE FEBRUARY 1, 1993
PURCHASE AMOUNT $75,000.00
0108 026 1464 0004 041 11:39 AM 01/20/88
REF NO 026-7000153

Mr. DINGELL. Thank you for being with us.

Ms. Hill.

Ms. HILL. Mr. Chairman, I am available here today to answer any questions that you may have or any other members of the panel may have.

Mr. DINGELL. We thank you for that.

Mr. Hodgman.

TESTIMONY OF WILLIAM W. HODGMAN

Mr. HODGMAN. Thank you, Mr. Chairman and members of the subcommittee. Thank you for allowing me to appear today.

I am a Deputy District Attorney for the County of Los Angeles and I was the lead prosecutor in the California State criminal proceedings brought against Charles H. Keating, Jr. It is from this perspective, based upon my experience in prosecuting the Keating case that I present my statement to this subcommittee.

Charles Keating and three other defendants were indicted in September of 1990 and, following 4½ months of jury trial, Keating was convicted on December 4th, 1991, of 17 counts of securities fraud in violation of California Corporations Code 25401 which prohibits misrepresentations and omissions of material facts in the sale of securities. On April 10, 1992, Keating was sentenced to serve 10 years in the California State Prison System, the maximum imprisonment permitted by law for the offenses for which he was convicted.

The toll caused by Keating's criminality upon over 17,000 southern Californians who collectively lost over $252 million was cruel indeed. Thousands of victims, many elderly and retired, were misled or outright defrauded of their hard-earned savings as well as painfully robbed of their dignity at a time in their lives when most of these victimized individuals did not have the means to earn money to replace what they had lost. Many were forced to radically change their lifestyles and alter their expectations for how they were to live out their remaining years. Money that had been set aside for grandchildren's college educations was lost and parents were forced to move in with their adult children because they had lost the financial ability to support themselves. Tragically, other victims ended their lives by committing suicide because they had lost everything, including hope, as a result of these deceptions.

The Keating saga dates back to 1984 when Keating's Phoenix-based parent company, American Continental Corporation, purchased Lincoln Savings and Loan in southern California. In late 1986, as government regulators began to restrict Keating's previously unfettered ability to directly invest the deposits of Lincoln Savings and Loan, Keating directed the commencement of a new money making scheme. Advised by what his trial counsel called "the best lawyers money could buy," Keating directed the sale of parent company debentures to be sold in leased space in the lobbies of its subsidiary, Lincoln Savings and Loan. Because of a lawfully allowed owner-issuer exemption, traditional safeguards for the investor in the marketing of securities were not present. For example, the bondsellers were not required to be trained and tested licensed brokers, no independent examination by an underwriter re-

garding the security of the bonds was conducted, and the bonds could not be resold in a secondary market like shares of stock.

Most, but not all, of the marketing of the ACC junk bonds complied with then existing regulations and laws governing the issuance and sale of securities. However, it was clear from the evidence presented at trial that Keating fully intended to "push the edge of the envelope" with regard to commingling the marketing of the bonds and the banking business. The primary interest was to "sell, sell, sell" the bonds rather than protect the interests of the investor.

The manner in which the bonds were sold to the individual bond purchasers followed a general pattern. A longtime customer, often a retiree, of Lincoln Savings and Loan would go to their local Lincoln branch to roll over an insured certificate of deposit as it was due to mature. For many of the customers, going to the Lincoln branch was a social event and more than just a visit to the bank. The customer and the teller would know each other on a first name basis. Many bond purchasers testified to the feeling of security they had in going to their local Lincoln branch, a feeling inspired as much by the FSLIC symbol on the door of the branch as by the personal trust the customer placed in the employees of Lincoln. At the teller's window, the customer would be directed to the ACC desk in the lobby of the branch if they desired to earn a percentage point or two over and above the interest rate offered on the insured CD accounts.

Typically, ACC leased an area 10 by 10 feet square in the Lincoln lobby, and it was in this area that the bond desk would be placed. The distinction between ACC and Lincoln was deliberately blurred in several respects. Keating had directed that Lincoln's logo be changed from the Lincoln head profile design to one that was identical with the ACC symbol. Also, the bondseller sitting at the ACC bond desk area of carpet leased by ACC was typically an individual who the customer was accustomed to seeing behind the teller window as a Lincoln employee.

The typical bondseller was a young, pleasant individual who was very enthusiastic about the product and who had very—and who had little experience in securities, finance, or investment. Based upon the verbal representations of the bondsellers, the customer was led to believe that the ACC bonds were a safe, secure and insured investment. In truth, they were not and the riskiness inherent in the bonds became more and more pronounced over the life of the bond program (December 1986 through February 1989) and as the financial condition of ACC steadily deteriorated. The typical Lincoln customer who became an ACC investor did so without knowing they were exchanging their investment in an insured CD account for one in uninsured junk bonds.

Regulations required that each investor in the ACC bonds be provided a prospectus describing the bonds. As was demonstrated at trial, the providing of a prospectus proved to be an inadequate meaningful safeguard for the investor. Generally, the prospectus was given to the purchaser almost as an afterthought after the sales pitch had been made and the purchase transaction had been completed.

Even when the victimized purchaser did receive a prospectus, the prospectus failed to adequately warn the investor in plain, clear language about the risks inherent in the bonds. The bond purchasers who testified at trial did not understand what was printed in the prospectus. For many, the prospectus was filled with largely incomprehensible legalese. For those Latino bond purchasers who spoke or read little English, the providing of a prospectus was even more of a futile gesture.

The individuals who sold the bonds who testified at trial state that they found the prospectus to be so long and confusing that they failed to understand what it stated and that it put them to sleep during their attempts to read it. Even a professor in finance at UCLA called by the prosecution as an expert witness to explain the contents of representative ACC prospectuses testified that he did not know the Latin expression "in parri passu" contained in the text of the prospectus and that he had to resort to reference books to understand its meaning.

Importantly, a key conclusion derived from the evidence produced at trial was that the bond buyers did not rely on the prospectus in purchasing the bonds; rather, they relied on what they were told about the bonds by the bond sellers. At trial, Ray Fidel—the former president of Lincoln Savings and Loan, the former director of the bond marketing program, and the individual who terminated the bond program in February 1989—testifies as follows in response to my question to him about what really sold the bonds:

> Two important things I think were the primary factors in the sale of bonds. The first would have been our people. Building a relationship with the customer and having that rapport and that trust on an ongoing basis. The second is our verbal representations to the customers about the track record and safety behind American Continental Corporation.

As a consequence of the reliance the bond purchasers placed upon the verbal representations of the bond sellers, sophisticated and unsophisticated investors alike were misled and, in some cases, defrauded. Furthermore, Fidel testified that ACC had lists of Lincoln depositors who had CD's due to mature and that these individuals were aggressively targeted in the ACC marketing campaign for the bonds.

The lessons of the Keating trial merit careful and serious consideration by the subcommittee. Based upon the evidence that was produced at trial and accepted by the jury as the basis for finding Keating criminally responsible for the fraud that was perpetuated in the sale of the ACC bonds in the lobbies of Lincoln Savings and Loan and later the ACC bond offices, whatever safeguards that were present in the marketing of the ACC bonds were not adequate to meaningfully protect the investor.

As was testified to at trial, everything in the ACC bond marketing scheme, while generally in compliance with regulations and the law, was designed to "sell, sell, sell bonds." With that design in mind, concerns of potential investors were minimized, the lack of insurance blurred, and perhaps most importantly the traditional image of the savings and loan was used to facilitate the purchase of securities that normally would not have been bought.

Thank you, Mr. Chairman. I would be happy to answer any questions that the committee might have.

Mr. DINGELL. Mr. Hodgman, you have given us a very powerful statement. We thank you both for your presence and your assistance.

Mr. Simon, thank you for being here with us today, too. We recognize you.

TESTIMONY OF LEONARD B. SIMON

Mr. SIMON. Thank you.

I would like to thank the chairman and the members of the subcommittee for inviting me to be here today. My name is Leonard Simon. I am a partner in the law firm of Milberg, Weiss, Bershad, Hynes & Lerach. I am in San Diego, California.

The people you have heard from so far this morning have told you about the efforts to put Mr. Keating in jail. My role in this matter was an effort to put money back in the pockets of the victims of Mr. Keating's fraud. I was co-lead counsel along with Joseph Kachet of Burlingame, California, for the class of investors who sued Mr. Keating and nearly 100 other persons or entities in a civil fraud suit brought under the securities laws and the racketeering laws aimed at returning as much of these investments as possible to the victims of this fraud.

Many of the people who were victims of this fraud are elderly people who live in southern California. Many of them lost their life savings.

Over $288 million was lost by individual citizens as a result of Mr. Keating's activities and the activities of others when American Continental and Lincoln Savings collapsed in April of 1989. We have recovered thus far in this litigation over 240 million out of that $288 million in losses. All by way of settlements.

We have also obtained a verdict for $1.2 billion, and we are involved in efforts to attempt to collect some or all of that verdict from Mr. Keating or from the handful of others who did force the case to a full trial and a jury resolution.

The recovery in this case does not undermine in any way the lessons to be learned from Lincoln Savings and the dangers of allowing banks and securities institutions to intermingle their activities. Litigation, unfortunately, will not always bring these kinds of recoveries and I applaud the efforts of the subcommittee to look at the root cause of the problem and attempt to avoid the next Lincoln Savings rather than to leave it to us and leave it to the civil system to attempt to bring a recovery.

We will try to do it every time it happens, but we would much rather have you avoid it for these people. This was a devastating, tragic loss for our clients in this case.

By way of background, let me explain that there were two types of investors in the American Continental Lincoln Savings combine. The first category is the category you hear about a lot and you will hear about for almost the remainder of my remarks. And they are people who bought the subordinated debentures of American Continental. They are mostly elderly people. They are mostly in southern California, and they purchased their debentures or bonds at Lincoln Savings branches or at American Continental offices next door. They were referred to in internal Lincoln documents as "the

weak, the meek and the ignorant." That document is attached to my written statement as Exhibit 1.

The second category of investors, just for sake of clarity, let me explain, is there were people who invested in American Continental in the more traditional securities investment way. They bought common stock, they bought senior debentures, they bought convertible securities through their brokers. Those people also lost money. Those people were also part of our case and made a recovery. And those people also were defrauded in the sense that the securities they bought were issued pursuant to financial statements which were fraudulent, and that is more of what I would call a garden variety securities fraud case that could occur with any company in any business, high tech, biotech, heavy manufacturing, in which a company sells its securities on false pretenses.

I could talk about that for a long time, but that is not the purpose of this hearing. And I want to focus on the former group, the people who walked into a Lincoln Savings branch looking for a federally insured deposit instrument and walked out of a Lincoln Savings branch with something very different, a junk bond, a subordinated debenture, sometimes called a bond, quite properly described as a junk bond, a totally noninvestment-grade bond, no different than the type that Michael Milken was peddling to other people.

The stories of every investor are a little different. But there are many, many common threads and that is what I would like to focus on.

The people who bought these bonds had typically banked with Lincoln Savings for many, many years, most predating the existence of Mr. Keating. The savings and loan was there for a long time. And they thought of Lincoln Savings as the savings and loan or the bank down the street. They thought of it as a place to put your safe money, your retirement money, the money you could not lose. And it was a building that they associated with that type of an investment.

These were not people who bought junk bonds from their brokers. These were not people who bought growth stocks from their brokers. Many of them had no other securities.

In many cases, the victims had a certificate of deposit at Lincoln Savings which was about to mature. And they would approach Lincoln Savings and discuss the fact that the certificate was about to mature and discuss rolling it over, so to speak. Or Lincoln Savings employees would call them and say, Mrs. Jones, your 2-year certificate of deposit is about to mature, would you like to roll it over?

As soon as they got an affirmative response to that, an effort would be made to switch, to switch the investor from the insured certificate of deposit to the uninsured subordinate debenture. And the investor would be told, it's just like a CD but it pays a little more interest. Those were the words that separated my clients from their life savings.

Questions about insurance, questions about FSLIC, questions about safety were cleverly finessed. Flat lies tended to be avoided. People would not say, yes, it's insured by FSLIC. People would talk around the issue. A clever, fast-talking 25- to 35-year-old, well-trained, attractive sales person would charm a 75-year-old retiree into not following up on the crucial question and would talk about

the billions of dollars in assets that ACC had and would use like "secured" and "safe" rather than answering questions about whether the securities were, in fact, FSLIC insured, which they were not.

I would like to focus on some of the key details of the sales which I apologize if I repeat anything that's been said. We're all talking about the same tragedy, but let me try to avoid repeating it.

Location of the sale. I think location of the sale was crucial. As you have heard, these bonds were sold originally in Lincoln Savings branches. They were not instruments of Lincoln Savings; they were instruments of the parent company, American Continental Corporation, but they were sold in the branch at a desk. It would be as if this table were owned by a different subcommittee or a different committee of Congress and we took the position that at this table we did the business of the Appropriations Committee, but we didn't put a sign up and tell anyone that.

And there was a desk in a federally insured savings and loan with emblems of the FSLIC all around the federally insured savings and loan. And at that desk, they did uninsured, non-FSLIC nonbanking business.

When the State regulators—the Federal regulators never did a thing about this. When the State regulators decided that was a bad idea, they forced them to move out of the branches, and so they did. They moved next door, they moved across the hall, they moved around the corner of a shopping mall. But, again, they set up the space so that a teller could very easily say to Mrs. Jones who walked in there to roll over her CD, if you'll just walk through that door and down that carpeted hallway and see Mr. Smith, he can take care of you. Or Mr. Smith would, in fact, come out and Mrs. Jones and walk her down the hallway into the other area. So I think a physical separation is a crucial issue.

Again, I have attached to my materials an advertisement from the Los Angeles Times. It's an advertisement for these junk bonds. It says, "Visit our representatives at any Lincoln Savings." "At any Lincoln Savings." And that is clearly the message that was being delivered, that these bonds were being sold at Lincoln Savings, whether it was a desk in the middle of the lobby or it was an anteway, alcove next door, it was treated as "at Lincoln Savings." And that is a matter that the subcommittee should carefully consider in terms of how to deal with Mellon or Dreyfus or anyone coming down the road.

Another issue which has been touched on is personnel and cross-selling. These elderly people were being cross-sold these bonds by bank tellers they had dealt with for months, years, or in some cases decades. And it was just impossible for them to distinguish that these people were wearing a different hat, were playing a different role today.

There was no separation between Lincoln and ACC because it was, frankly, Mr. Jones who had always taken their deposits and put them in a federally insured account or had guided them to a certificate of deposit, federally insured. One day, the same Mr. Jones guided them into an uninsured deposit. And it was just beyond their ability to understand how this could have happened.

Next point, efficacy of the warnings in a prospectus. I have attached the prospectus as Exhibit 5 to my remarks. You've already

heard about it. It does say, in bold face, on the first page, that these debentures are uninsured.

All I can tell you is that hundreds of the most honest and genuine senior citizens in this country have met with us, have testified in our trial, have testified before other committees of this Congress, have testified in Ms. Hill's trial and Mr. Hodgman's trial, and they routinely say, and their testimony was accepted by juries, that they did not understand that these debentures were uninsured.

They were presented with a 50-page, fine print prospectus. And as nice as it is to say that this warning was contained on the first page, a 50-page, fine print prospectus simply intimidates someone who is 75 years old who is unsophisticated financially, who may have never purchased a security before and who trusts the person he does business with.

I think the lesson to be learned is that a prospectus will not cure this problem.

Mr. DINGELL. I don't normally interrupt, but I note here attached also to your statement, and without objection the entirety of the appendices that you have been referring to will be inserted in the record. But on the letterhead of Lincoln Savings, on your Exhibit 1, at the end appears this wonderful point. There are 13 points. And number 13 says this: "Always remember the weak, meek and ignorant are always good targets."

Mr. SIMON. That is the attitude of the people that we dealt with in this case. And, unfortunately, I think that without some kind of different regulation—we're never going to eliminate those kinds of people from the world. But without stronger protection for people, we are making it easier for people who would think like that to prey upon the citizens of this country.

There is another statement, another interesting document in the package, Mr. Chairman. If you looked at Exhibit 4 attached to my materials, you will also see what they call a verification of deposit. And at the top of it it says Lincoln Savings. And—which is a savings and loan. It uses the word "deposit" which sounds like a deposit to any of us, I think, it would sound like a deposit.

But if you look at the listed deposits, the first one is a savings account. That's perfectly all right. And the next two are these subordinate debentures or junk bonds.

So Lincoln was using bookkeeping and computerized records and confirmations it was sending out to my clients to further convince them this was all the same, that part of it was Lincoln and part of it was ACC but it was all one big package, it was all one big company, and they were all deposits.

And when you combine the word "deposit" with the words "savings and loan," I think you deliver an unmistakable message to the purchaser that he or she is getting an insured instrument.

Another crucial issue is the ease of transfer. An investor could walk into a Lincoln Savings branch, fill out a form, not write a check, not turn over any cash, and simply switch his or her money from an insured to an uninsured instrument. And that seems, again, to have been crucial. People hardly knew they had done anything. They had taken their life savings, whether it was $10,000 or $50,000 or more and they had moved it from an insured account

to an uninsured account in the blink of an eye, and they did not know they had even done anything significant.

To them it was no different than switching from checking to savings or from savings to a 2-year certificate of deposit. It was a minor modification of their arrangement with a federally insured bank. And it was a disaster for them.

Mr. DINGELL. As manifested by this "verification of deposit" mentioned in your Exhibit Number 4?

Mr. SIMON. Yes, sir.

Had they had to withdraw their life savings and write a check to Merrill Lynch, for example, to make an investment, many of these people—most of these people would not have done it. They didn't deal with the Merrill Lynches of the world, they didn't withdraw their life savings for any purpose. And the problem would not have occurred.

It was as easy as—when I think of Dreyfus, I think of these telephone switching mechanisms where you can move your money from the high-growth account to the balanced account by calling on the phone and talking to a machine and punching in your account number.

And it scares the heck out of me to think about people moving their money from an insured Mellon account to an uninsured Dreyfus mutual fund with the push of a button on their telephone or the like.

Mr. DINGELL. It's also fair to observe that it is not required by the bank regulators that they submit a prospectus, is it? That's an SEC requirement.

Mr. SIMON. That is an SEC requirement. But in this case, it applied because these securities were not sold by a bank; they were sold by a holding company, the parent holding company, American Continental.

So you are correct, Mr. Chairman. But the situation is even worse. Not only is a prospectus not required in certain kinds of bank transactions, but here a prospectus was required and it still didn't do any good. People did not understand what they were doing.

We had clients who had large holdings, say $500,000, and broke them down into five blocks of $100,000 a piece in order to get the FSLIC insurance, they thought. I can't think of a more stark illustration of the fact that people believed these were insured than that they broke them into blocks of $100,000 to take advantage of the insurance, and put them in the names of their children or their spouses, which is perfectly legal to do, and is considered prudent if one has $500,000 in a financial institution. But they had no insurance and they did not know it.

Mr. DINGELL. Now, on a transfer with an ATM machine, they wouldn't even talk to somebody; they would just——

Mr. SIMON. I think again, as Chairman Levitt was saying, these things tend to continue down a road. Once you start down the road, they continue that way. And it's quite possible that 5 years from now or 5 months from now, you'll be able to transfer money from an insured account to an uninsured on an ATM machine.

Mr. DINGELL. By pushing a few of those pretty red buttons on there.

Mr. SIMON. I think the chairman is correct about that.

The last point I want to make in terms of the structural problem, and I think this is a structural and an atmospheric problem, it was the structure of the institution and the atmosphere of the institution that lulled people into a false sense of security.

But the last point, maybe an obvious one but one that it is important to underscore is that Lincoln and ACC were selling their own securities. Had they been selling IBM stock at Lincoln teller windows, I don't think anyone would have been fooled. I think people understand if they don't want to buy common stock and they understand that the return on a common stock is not guaranteed. It was that these were instruments issued by the savings and loan or its parent or subsidiary company that caused the confusion on the part of our clients.

It is possible that a cooling off period would be helpful here. We had many clients who made the switch, bought the debenture, went home, thought about it, possibly discussed it with a spouse or a friend or an adult child, and wanted to bail out of the investment, and that was impossible. It may be that, like selling magazines or encyclopedias door to door, I know in many States it is true that you have a 7-day cooling off period, and that might be helpful in this area as well.

Or having people at least take home a piece of paper which says, in bold face, this is not a federally insured instrument. If you required an investor to sign it and to take it home, it again might work at least at the margins to reduce the number of people who are going to be victimized.

But as long as you allow people to sell noninsured instruments at what appears to be an insured institution, you are going to have this kind of a problem.

I would like to close my remarks by underscoring again, we made what we think is a remarkable recovery for these people in this case because we had the advantages of the federal securities laws to work with. The subcommittee should not count on that occurring in the future. There are not the deep pockets that could be reached in this case. The accounting firms and the law firms and the others who assisted Mr. Keating and who paid most of the money to recover this.

There are efforts under way as the committee may know, to water down the protections under the securities laws, which would make this a more difficult result to obtain in the future and the key seems to me it would be to nip it in the bud and not allow it to occur.

And finally I would like to answer a question, if that's permissible, put by Mr. Schaefer earlier. I am not sure you got a full answer to the SIPC question, and that is a problem that we face as well. If I could illustrate it briefly, I think it might be a little clearer.

If an investor purchases 100 shares of stock and he purchases it from Merrill Lynch and it is subject to SIPC protection, what that means is that if Merrill Lynch went out of business, not IBM, but if Merrill Lynch went out of business and the investor could not get his shares out of Merrill Lynch because it was in a receivership but the investor had $10,000 invested in IBM stock and the stock had

not gone up or down, SIPC would give him his $10,000 or his shares. It would protect the investor from a failure by the brokerage institution.

If IBM stock dropped from its current level to zero, SIPC would do nothing for anyone, whether Merrill Lynch was in business or out of business. It does not protect you against investment losses of the traditional kind, the market going down, the stock going down, the company failing. It protects you from a failure at the brokerage account which is holding your securities.

This is a danger. People do say, oh, there is not FSLIC insurance but there is SIPC insurance, and it is black and white, entirely different. It would not have protected my clients. It will not protect citizens from the kinds of losses that they are protected for in FSLIC. FSLIC says you put in $10,000, you get back $10,000—we promise you, we, the United States of America promise you that you get back your principal, no matter what happens to this institution and SIPC only promises that if you invest in the stock market you will get the return you would expect from the stock market, good or bad, even if the brokerage that you choose to leave your securities at fails.

I hope that sheds some light on that subject.

Mr. Chairman, members of the subcommittee, thank you very much for your time and for inviting me here.

[Testimony resumes on p. 152.]

[The prepared statement of Mr. Simon, follows:]

TESTIMONY OF LEONARD B. SIMON

My name is Leonard B. Simon. I am an attorney in San Diego, California. Along with Joseph Cotchett, a lawyer from Burlingame, California, I was co-lead counsel for plaintiffs in the Lincoln Savings & Loan securities fraud litigation, representing a class of several thousand people who lost their investments, and in many cases their life savings, when Lincoln Savings & Loan collapsed. I am sure you all recall Lincoln Savings, headquartered in Phoenix, Arizona and Irvine, California, but with all its branches in California. Lincoln was run by Charles Keating, Jr., who is now serving time in prison.

Over $288 million was lost by citizens who invested in Lincoln Savings, or more precisely, those who invested in its parent company, American Continental Corporation. American Continental owned and controlled Lincoln Savings, and collapsed at the same time as Lincoln did in April 1989. We represented a class of people who bought the stock or bonds of American Continental. Through litigation in federal court in Arizona, we have been fortunate enough to recover over $240 million in cash for these people. We obtained a jury verdict for over $1 billion against the defendants who did not settle the case, and we are still seeking to collect additional funds from Mr. Keating and a few others.

This excellent recovery does not undermine in any way the lessons to be learned from Lincoln Savings, and the dangers to be avoided. Litigation will not always bring such substantial recoveries, and there were vices present in the Lincoln Savings situation that Congress must watch carefully.

One of those vices, and the one I have been asked to focus on today, concerns the sale of securities by savings and loans (or

banks) and their affiliates. This was clearly a serious problem in Lincoln Savings.

By way of background, let me explain that the investors in the Lincoln Savings case fell basically into two categories.

The first category consisted of people, mostly senior citizens living in Southern California, who bought certain bonds called "subordinate debentures" issued by American Continental. They bought them exclusively at Lincoln Savings branches, or at tiny American Continental offices set up adjacent to Lincoln Savings branches. No stock brokers were involved. Many of these elderly people were specifically targeted (see an internal document referring to the "weak, meek and ignorant" attached as Exhibit 1) and invested and lost their life savings. That is the group I want to talk about today. Their losses were over $170 million.

The second category of investors consisted of people who bought stock or other securities issued by American Continental from their stock brokers. This group lost about $110 million, and was also the victim of a financial fraud, in that the financial statements of American Continental were false and misleading. However, they were not victimized in the manner I am going to discuss in the rest of my remarks. They did not buy their securities directly from Lincoln Savings or from an affiliate, but rather bought through a traditional stock broker.

The people who bought subordinate debentures were really the victims of two separate frauds. Like investors in other securities fraud schemes, they bought the securities of a company that was issuing false financial statements, and that was defrauding federal

regulators to stay in business. That gave them a claim under the federal securities laws.

But the people who bought American Continental subordinate debentures were defrauded in another way, and most would not even agree that they were "investors" in American Continental. They were depositors or would-be depositors who approached Lincoln Savings looking for a federally insured deposit-type instrument, and were defrauded into purchasing a security. This is the central fact that is most relevant to the Subcommittee's concerns about relationships between banks and securities firms.

As I said earlier, the purchasers of American Continental's subordinate debentures were predominantly senior citizens who lived in Southern California. That is where Lincoln Savings operated. Although the story of each investor is a little different, there were many common themes.

Many of these people had done their banking with Lincoln for many years, well before Mr. Keating took over. Many of them had checking or savings accounts, or certificates of deposit, at Lincoln. Of course, those bank accounts and certificates were protected by FSLIC insurance up to $100,000.

There was an FSLIC sign on the door of each Lincoln branch. These people were comfortable with the idea that Lincoln, like other S&L's and banks, was a place to put your money if you wanted to be sure not to lose it.

In many cases, the victims had a certificate of deposit at Lincoln that was about to mature. The victim would approach a Lincoln employee, or a Lincoln employee would call the victim, to discuss "rolling over" the maturing CD into a new CD. The Lincoln

employee would then attempt to "switch" the victim from a CD to a subordinate debenture of American Continental. This scheme was vital to Keating's empire, which was running out of cash; since cash invested in American Continental was not regulated to nearly the degree that S&L deposits were, the "switch" was critical to the success of the enterprise.

Because of this great need for cash at the parent corporation, Lincoln employees were paid bonuses, and entire branches were paid bonuses, based upon the volume of sales of subordinate debentures. Thus virtually the entire office was involved in "cross selling," or switching people out of insured instruments and into these debentures.

The debenture would be described by Lincoln or American Continental employees as "just like a CD, but paying a little more interest." Questions about insurance would be cleverly finessed. Victim after victim testified -- in our civil trial, in the criminal trials, and before the House Banking Committee -- that they believed that they were purchasing an instrument with federal insurance or its equivalent. None of these people understood that they were buying junk bonds from a highly non-traditional, and financially shaky, S&L holding company.

I would like to highlight a few of the details of the victimization of these people.

(a) Location of the sale. In the early stages, these debentures were sold right in Lincoln offices. American Continental had purportedly "leased" a desk or a small corner of the office, and the debentures were sold there. (See advertisement attached as Exhibit 2.) Later, the California Department of

Savings & Loans forced this activity to be moved out of the branches, motivated by many of the concerns I am voicing today. (See letter from California Department of Savings & Loan attached as Exhibit 3.) This change had little or no effect, as American Continental leased small offices adjacent to the Lincoln branches, and the teller simply sent the victims down the hall, around the corner, or across the way to buy the debentures.

(b) Personnel and cross-selling. Although there was a purported distinction between Lincoln employees who took deposits and American Continental employees who sold bonds, these groupings of employees overlapped and often merged. Many of the bond salespeople were former tellers known to and trusted by the victims. Also, most of the persons acting as tellers engaged in "cross-selling" by referring the victims to the bond salespeople. Indeed, confirmations from Lincoln/ACC listed these debentures as Lincoln deposits. (See confirmation attached as Exhibit 4.)

(c) Efficacy of warning in prospectus. The American Continental debentures, like any federally registered security, were sold pursuant to a prospectus. The prospectus stated in large letters on the cover page that the debentures were not federally insured. (See Prospectus excerpt attached as Exhibit 5.) Nevertheless, this warning did not protect the victims from losing their money. Why? Many people did not get prospectuses. Others got them late. Others did not read them. Others did not understand them, or were intimidated by 50 pages of fine print. Still others thought they understood from the oral sales pitch that the debentures had some form of protection similar to, but not the same as, federal insurance, so the warning would not concern or

enlighten them. In sum, requiring a prospectus and a warning in that prospectus does not solve the problem. To put it another way, simply prohibiting fraud in the written prospectus will not cure this problem.

(d) Oral representations. It appears that most debenture salespersons were trained not to say that the debentures were federally insured, but simply to duck the issue, confuse the victim, or reassure the victim without stating a literal falsehood. Thus, simply prohibiting sales personnel from lying about federal insurance does not appear to solve the problem.

(e) Ease of transfer. Because many of the victims had money in Lincoln accounts or CDs, they could buy a debenture without actually writing a check. The ease and simplicity of signing a simple form prepared by Lincoln or American Continental employees appeared to lull the victims into a sense of security, a sense that they were making only a minor change in their investment. If they had to withdraw their life savings, and affirmatively place it in a separate non-Lincoln investment, the enormity and danger of what they were doing might have sunk in.

(f) The core of the problem -- association between the security and the S & L. The core of the problem, in my judgment, was the association between the debenture and Lincoln Savings. Whether it was the familiar surroundings, the safe name, the common logo, the known personnel, or some combination of those factors, victims purchased these debentures who would never have invested their life savings (or any appreciable sum) in comparable instruments issued by another corporation, sold by a stock broker.

These victims did not have portfolios with other junk bonds in them.

The message that these instruments were connected to Lincoln, and that Lincoln was a federally insured financial institution, was the crucial message delivered. Other information, including disclaimers, did not seem to erase or undercut this message.

Thus the lesson of Lincoln Savings, from this perspective, appears to be to keep the psychological separation between the S&L (or bank) and its uninsured affiliate as clear as possible.

-- Office space should be entirely separate, not next door.

-- Names and logos should be entirely different.

-- Personnel should be entirely different, and should not be shifted from the insured institution to the uninsured affiliate.

-- Investments should require a withdrawal from the S & L and the writing of a check to the uninsured entity, or other clear indication that the investor understands that he or she is withdrawing money from an insured institution and investing it in an uninsured one.

-- There is a particular danger when the S & L or affiliate is selling its own securities. That is, if a bank affiliates with a brokerage, and the brokerage employees sell IBM stock, most people will understand that IBM stock is not federally insured. However, when a brokerage affiliated with a bank sells stocks or bonds issued by the bank, by the affiliated brokerage, or by some other related parent or subsidiary company, the likelihood of confusion is high. A security issued by the insured institution (or a related entity) presents the highest degree of concern in this

regard. Congress should consider prohibiting such sales or allow them only under carefully defined circumstances.

-- Congress should consider establishing a cooling off period in which the transaction could be rescinded, and requiring a very clear warning -- "NOT A FEDERALLY INSURED DEPOSIT" -- in a one-page document that had to be signed.

Thank you for inviting me to testify, and for your interest in this serious problem. I hope you can avert the next Lincoln Savings, at least from the standpoint of innocent bank or S&L depositors who are hoodwinked into investing in related companies.

LINCOLN
SAVINGS

18200 Von Karman, Ste. 1100, Irvine, CA 92715/(714) 854-4780

ACFS SLIDE PRESENTATION

O.K. Gang, here's what you've all been waiting for.
Enclosed please find :

* 55 slides
* cover sheet describing each slide
* 6 pages of information about each slide

Please read and reread this presentation until the detailed verbage contained on these 6 pages flows from your mouth like carbon monoxide from the exhaust pipe of a MACK truck. Seriously, the worst thing you can do, is forget to look this over, and read the script to yourself while looking at the slides, before you give the presentation to a live audience. There is a lot of information here, and it took quite a few hours to process. But don't get worried as though it is overwhelming. It took so long to produce, because we've refined it down to clear, concise, and hopefully somewhat interesting subject matter.

If you have any questions, call Mike or myself at Koll.

Sincerely,

William R Pomeroy

William R Pomeroy (Bill)
Marketing

P.S. The slides are numbered so that the blue numbers face you as you place them in the slide wheel. They go in upside down-yes-that's why if you hold the slide up to the light to look at it with the blue, handwritten number right side up, the slide will be upside down! Make sense? I didn't think so.

EXHIBIT 1

CAPITALIZE ON THIS:

1. BLACK MONDAY – OCT 19,

Stocks, bonds, mutual funds, gold all fluctuating in a non-rational manner.

C.D.s #1 investment right now. Compare bond to C.D.- fixed.

A.C.C. OTC stock down 3/8 pt. Tuesday unchanged. Not heavily traded. Charles Keating owns majority of stock.

A.C.C. does not invest heavily in the stock market, only 1% ($60 million) of total assets are here. Losses were paper losses.

2. "Diversification is the inclusion of a variety of vehicles in a portfolio for the purpose of reducing risk." Defined in the textbook <u>Fundamentals of Investing</u> by Gitman and Joehnk.

A.C.C. 13 subsidiaries in several different industries.

A. Financial Services

Lincoln Savings- away from loans. Diversified into real estate, equity investments, etc. Net earnings and net worth hit record levels. Net earnings record high 1985- current net worth around $200 million.

B. Insurance- 3 Companies

American Founders Life- top 25% in asset size. Rated A excellent by Best.

C. Real Estate

Largest private land owner in ~~[illegible]~~ ARIZONA

Estrella project- land bought 18-24 months ago for $3000-$4000 an acre and now selling for $16,000-$20,000 an acre.

Phoenix growing 100,000 people a year, making it the fastest growing metropolitan area in the country.

High turnover investments.

Residential, commercial and hotels.

3. THE NATURE OF A HOLDING COMPANY

Buy and sell subsidiaries as needed.

4. FORBES

28th in profitability out of 1,012 of what they call the most profitable companies in the U.S.- over 5 year average. 40th last year.

12th in growth. #1 in 1985.

13th in stock performance.

2nd most profitable thrift.
Behind Columbia

5. COMPARING TO A TAX FREE
12% x 1 - tax rate
i.e. 12% (1-.28) = equivalent tax free

- Bond rate (1- bond rate)

6. USE INTEREST CALCULATION (617) ON YOUR COMPUTER.

People are blown away at how much more interest they earn in a bond.

7. FLOWER BOND PROVISION

8. ALWAYS COMPARE TO A C.D.

9. SHOW EARNINGS HISTORY AND EXPLAIN FLUCTUATIONS.

10. DON'T MAIL OUT PROSPECTUS, GET THEM IN!

11. ACCOUNT RETENTION CALL REPORT.

12. CAPITALIZE ON MONTHLY INTEREST- REINVEST- YIELD HIGHER.

13. AND ALWAYS REMEMBER THE WEAK, MEEK AND IGNORANT ARE ALWAYS GOOD TARGETS.

CONTINENTAL
CORPORATION
Post Office Box 19614, Irvine, CA 92714

November 11, 1987

Hi Again!

Two memos in the same week - what a bargain. Ray would not be impressed. We can now draft funds from another institution to A.C.C. for the purchase of Subordinate Debentures. This is to be done using your branch's Draft form. All information will be filled out as for Lincoln, with two exceptions:

1.) In the "account number" line it is important to specify "American Continental Corporation Subordinate Debenture Account Number: 0XX-7000XXX".
2.) Make the Draft payable to:
American Continental Corporation
c/o Lincoln Savings

Of course I've enclosed a "Visual Aid" for your ease and convenience. Quite the gal, eh? Do feel free to frame and display it proudly! I hope this will make your life a bit easier, ESPECIALLY with the influx of new purchases anticipated!

Good Luck, and keep that Rocky attitude!

See ya,

Dawn

P.S. It would help me keep up with your predicted "wicked" selling pace if the Blue/Pink purchase agreement copies are sent in daily, and BE SURE the bond is posted on the same date stated on the purchase agreement. If the two do not agree for any reason, Please, Please, Please let me know. This can cause me more grief than you'll ever know (or ever care to know!). Thanks for your help!

LINCOLN SAVINGS
18200 Von Karman, Suite 100
Irvine, California 92715
(714) 864-4700

DRAFT

VALUE RECEIVED & CHARGE ACCOUNT OF

NAME Edna Gert Snidlip

ADDRESS 1 Geriatric Way

CITY Retiredville, Ca. 92627

ACCT NO 4658432212

RETURN OF PASSBOOK REQUESTED

Amer. Cont. Sub. Debt.

ACCOUNT NO 35-7000999

DATE 11-15-87

EFFECTIVE DATE Upon Receipt

No. 35- 0124

PAY TO THE ORDER OF American Continental Corporation C/O Lincoln Savings and Loan

$ 20,000.00

***** Twenty Thousand ***** DOLLARS

PASS BOOK BALANCE $ 20,000.00

PLEASE REMIT DIRECTLY TO
LINCOLN SAVINGS c/o
AMCC Representative

TO. Home Federal Savings And Loan
666 Competitor Drive
Retiredville, Ca. 92627

SIGNATURE OF ACCOUNT HOLDER

AUTHORIZED SIGNATURE

SA-04-35 (8/85)

New Offerings

9.50% 1-YEAR

10.50% 2-YEAR

SUBORDINATE DEBENTURES

Minimum investment $2,000

Monthly interest

Offered exclusively in California

Eligible for Self-Directed IRAs

Visit our representatives at any Lincoln Savings

AMERICAN CONTINENTAL CORPORATION

LA Times - 3/29/88

EXHIBIT 2

some, and this matter is of concern to this Department. We, therefore, affirm our denial of your application. Sales of the debentures on the premises of Lincoln are to be discontinued as of completion of the original $200 million issuance or August 1, 1986, whichever is earlier.

Very truly yours,

William D. Davis
Chief Deputy Savings and Loan Commissioner

WDD:lfm

cc: Darrel W. Dochow, Executive Director, ORPOS
Federal Home Loan Bank Board

KS 526751

80-222 104

LINCOLN SAVINGS
A Subsidiary of American Continental Corporation

VERIFICATION OF DEPOSIT

This information is believed to be accurate but is not guaranteed. This form is being supplied to the recipient solely as a courtesy, and no warranty is expressed or implied.

TYPE OF ACCOUNT	ACCOUNT NUMBER	CURRENT BALANCE	DATE OPENED
SAVINGS	20-13248	$ 7,897.98	2-12-88
SUBORDINATE DEBENTURE	20-7000205	$ 18,000.00	11-19-87
SUBORDINATE DEBENTURE	20-7000364	$ 6,000.00	2-12-88
		$	

SIGNED

9-23-88
DATED

EXHIBIT 4

A433375 33-13228

226058

$200,000,000
American Continental Corporation
Subordinate Debentures
(Issuable in Series)

Minimum Purchase: $2,000

American Continental Corporation (the "Company") is offering directly to the public up to $200,000,000 aggregate principal amount of its Subordinate Debentures (the "Debentures"). The Company intends to offer the Debentures for sale directly to the public from time to time pursuant to this Prospectus. Based upon market conditions, the Company periodically will establish series of Debentures which will conform to the description of the Debentures set forth in this Prospectus. From time to time, series of Debentures ("Zero Coupon Debentures") may be issued which will not bear interest and will be issued at a substantial discount from their principal amount. As of April 28, 1987, the Company had sold approximately $27,800,000 aggregate principal amount of Debentures in seven series.

The Debentures will be offered to the public through the selling efforts of full-time employees of the Company and its affiliates other than Lincoln Savings and Loan Association ("Lincoln Savings"), at each of Lincoln Savings' branches in California and at the Company's offices in Phoenix, Arizona.

JUN 25 1987

Unless otherwise stated in a Prospectus Supplement, interest on each series of Debentures, except Zero Coupon Debentures, will be payable on the 28th day of each calendar month, with respect to interest accrued through the last day of the preceding calendar month. Each Debenture, except Zero Coupon Debentures, will bear interest from the date on which payment of the purchase price is received by the Company. The Debentures will be redeemable on the dates, and at the prices, set forth in the Prospectus Supplement relating to such series.

The Debentures will be subordinated to all Senior Indebtedness (as defined) of the Company. The Indenture under which the Debentures are to be issued does not limit the amount of Senior Indebtedness the Company may incur. At December 31, 1986, the Company had outstanding approximately $252,350,000 of Senior Indebtedness. Unless otherwise stated in a Prospectus Supplement, the Debentures will be sold in minimum denominations of $2,000. See "Description of Debentures."

40

Because the Debentures are being offered by the Company directly to the public without a firm underwriting commitment, no assurance can be given as to the amount of Debentures that will be sold, and the Company is not required to sell any minimum aggregate principal amount of Debentures or of any series of Debentures. There can be no assurance that a market for the Debentures will exist after the offering. Accordingly, it may be difficult to resell the Debentures, particularly because it is anticipated that various series will bear different interest rates and have different maturity dates. For a description of certain risks and other factors, see "Special Factors."

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

THE DEBENTURES BEING OFFERED ARE THE SOLE OBLIGATION OF THE COMPANY AND ARE NOT BEING OFFERED AS SAVINGS ACCOUNTS OR DEPOSITS AND ARE NOT INSURED BY THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION.

	Maximum Price to Public(1)	Underwriting Discount	Maximum Proceeds to Company(1)(2)
Per Debenture	100%	-0-	100%
Maximum Aggregate Offering Price(3)	$200,000,000	-0-	$200,000,000

(1) If any Debentures are issued at an original issue discount (Zero Coupon Debentures) the Price to Public and the corresponding Proceeds to Company per Debenture will be such lesser amounts as set forth in the Prospectus Supplement for that series. In no case shall the Maximum Price to Public of all series of Debentures exceed the amount set forth under Maximum Aggregate Offering Price.

(2) Before deducting expenses payable by the Company, estimated to be $195,000 plus $25,000 per series. See "Use of Proceeds."

(3) There is no minimum amount of Debentures required to be sold by the Company.

This Prospectus does not contain complete information with respect to each series of Debentures proposed to be sold. A Prospectus Supplement with respect to each series of Debentures offered hereunder will set forth, with regard to such series, (i) the maximum aggregate principal amount, interest rate and maturity date of the Debentures of such series and (ii) the redemption provisions with respect to such series. Debentures of any series may not be sold and offers to buy may not be accepted unless the purchaser has received both this Prospectus and the Prospectus Supplement relating to such series.

The date of the Prospectus is May 1, 1987

EXHIBIT 5

Mr. DINGELL. Mr. Simon, you have given us most valuable assistance and your kindness to the committee is very much appreciated.

The Chair is going to recognize my good friend from Colorado, Mr. Schaefer.

Mr. SCHAEFER. Thank you, Mr. Chairman, and Mr. Simon, thank you for that—you're right. I didn't have a complete answer. As I see it now, I can understand it.

You are all to be commended for what you have been able to accomplish in this situation. Let me ask a question. Were any of the sellers, who were basically defrauding, prosecuted?

Mr. HODGMAN. Mr. Schaefer, if I may address that first, in our particular prosecution in California at the State level the bond seller representatives who testified were all given immunity because technically under California State law they were strictly liable for the representations or omissions that they had made.

The irony of the situation is, as has been described in the testimony, many of these bond sellers were young, enthusiastic individuals who really believed in their product. They sold these bonds to their parents. They sold these bonds to their neighbors. They sold these bonds to their in-laws, and they too never realized the truth about the riskiness of the bonds that they were selling.

They, too, in a sense were duped.

Now as a matter of California State law, they had to be immunized in order to obtain their testimony.

Ms. HILL. Mr. Schaefer, to answer your question, with regard to the Federal criminal trial, none of the bond representatives were prosecuted. Essentially we targeted the individual who was in charge of the program, Ray Fidel. He was the President of the bank. He recruited personally all of these young, energetic bond representatives.

Mr. SCHAEFER. So none of the managers—Fidel was the one you really went after.

Ms. HILL. In our trial the focus of the investigation was the fraudulent financial statements. It was not the manner in which the bonds were sold, so all of the bond representatives including Mr. Fidel himself to some extent did not know about the financial fraud that was occurring in Arizona. That was hidden from view to almost everyone involved except for a very select number of people.

Mr. SCHAEFER. Interesting. Mr. Simon, I was looking through your testimony here and at some of the various documents you had. There is one here, a letter from Continental Corporation of November 11th, 1987. It starts, "Hi, again"—what, may I ask, in the second paragraph does it mean when it says "I have enclosed a visual aid for your ease and convenience, quite a gal, huh?" What was this all about?

Mr. SIMON. This is, first of all, an internal document they sent around to bond salespeople. I am happy you brought it up. It also may make us all cynical about how the world runs, but if you turn a couple of pages, Mr. Schaefer, you will see the visual aid is the—it is the document marked Draft up at the top. It is how to fill out a form to have someone switch—the Edna Gert Snidlip, 1 Geriatric Way, Retiredville, California. That's the gal they are referring to.

Mr. SCHAEFER. Oh. OK. Again you are to be commended. Some $288 million was lost by some 17,000 investors, if I am understanding right, you were able to recover about $240 million of this, at least to this point in time. Is there any more recoverable out there?

Mr. SIMON. We have a huge judgment against Mr. Keating and a couple of other people. I think it is fair to say that as to one of those other people we may recover a million dollars or a million and a half, which is a lot of money but compared to $240 million it doesn't change the total very much. As to another, I think the person is entirely judgment-proof, and as to Mr. Keating, there are people who have a wide variety of beliefs as to whether he stashed away large amounts of money overseas and if he has, I think that money will go in part to the Government to recoup their losses and in part to the investors so we have our fingers crossed that Mr. Keating will actually bring us to a 100 percent recovery but we're quite pleased with what we have gotten thus far.

Mr. SCHAEFER. You have a tremendous job in saving a lot of these investors out there from——

Mr. SIMON. As someone said earlier, Mr. Keating did surround himself with the best lawyers money could buy and the best accountants money could buy and in large numbers, and the thing that distinguishes this case from many others is that there were a substantial number of accounting firms and law firms which got very close to Mr. Keating and assisted him in doing what he did and we got a very substantial recovery. I think we recovered close to $100 million from, a total of $100 million from three of the Big Six accounting firms. He had all three of them going at the same time and substantial amounts from two or three or four large national law firms.

If he had done it all by himself it would have been the usual sad story of a terrible fraud and no one to recover from.

Mr. SCHAEFER. For any of you sitting on the panel today, I am looking for parallels on the possible Mellon bank merger with Dreyfus and what happened with Lincoln S&L.

Do you see any parallels that are possibly out there? You have mentioned a number of things that we could do in legislation but is there anything that is moving in this direction that concerns you?

Mr. SIMON. I would be happy to start, if that is OK.

I don't know the specifics of what Mellon and Dreyfus intend to do when they merge, but I think the parallel, the first parallel is pretty clear, which is that if a Mellon depositor can walk into a Mellon bank the day after the merger and can purchase a Dreyfus mutual fund, or worse yet a Mellon-Dreyfus mutual fund or Mellon mutual fund, and can purchase it without really understanding that he or she is investing in something very different than what he or she has been depositing into the Mellon bank for the previous year or years, that is the nub of the problem is to not have Dreyfus trade off the Mellon name and not have Mellon depositors be misled or confused as to what they are doing when they buy a Dreyfus instrument, and have them understand that a Dreyfus instrument is just like picking up the phone and calling Fidelity and putting your money with Fidelity.

Mr. SCHAEFER. That would be similar then to the American Continental and the tie-up with Lincoln, et cetera.

Mr. SIMON. Right. It seems to present the same danger of confusion when you have a long-standing, well-respected bank issuing federally-insured instruments and all of a sudden one day it is joined at the hip, so to speak, with a mutual fund which is selling something very different, maybe something that is just fine for the right investor but very different, and the key is to deliver the message loud and clear that it is different or just simply keep them separate.

Mr. SCHAEFER. Mr. Hodgman?

Mr. HODGMAN. Yes, Mr. Schaefer, if I may augment what Mr. Simon said.

There is an element of appreciation of risk that has to be understood as well and when one walks onto the premises of a used car lot, for example, one has an appreciation of risk. They are prepared to go in and ask hard questions about a car which may or may not be a lemon.

When one walks into the lobby of a savings and loan or a bank, the same appreciation of a risk is not present, as was testified to at trial, as was evident in hundreds of interviews of victimized bond purchasers. When these victims walked into Lincoln Savings & Loan they felt safe, they felt secure. There was an aura of safety and there was a tremendous aura of trust built over a longstanding relationship between the people who work behind the teller's window and the customers. There was not the same appreciation of risk as when you would walk into, say, the offices of a stock brokerage or an independent bond office.

Mr. SCHAEFER. It was interesting to me what you said about the regulators. If I am reading you right on this, your point was that it was the State regulators, and not the Federal regulators, that really got in and started uncovering this, is that correct?

Ms. HILL. The State regulators came in and stated that they believed the sale of bonds in the branches might potentially mislead investors, so they asked American Continental Corporation to physically move the desks, that is correct.

Mr. SCHAEFER. The Federal regulators had nothing to do with any of this? I mean what was their role or what eventually was their role?

Ms. HILL. The SEC was involved in that this security was issued under the issuer exemption and also there was banking regulation going on at that time by the Federal Home Loan Bank Board, so there were a number of regulators looking at various aspects of Lincoln Savings & Loan.

Mr. SCHAEFER. OK. Anyone else on this issue?

Mr. SIMON. I think as one of the witnesses said on the earlier panel, I believe it was Chairman Levitt, bank regulators are interested in the solvency of the bank and this matter really does not directly concern the solvency of the bank. It concerns consumer or investor protection and I don't think—we saw thousands of pages of documents from the Federal banking regulators and I don't recall their being a discussion of this particular problem as being within their area of concern.

The State regulators did, just being closer to the scene, I think, did grow concerned about selling bonds right in the lobby of an S&L and did push them down the hall.

Mr. SCHAEFER. I think that's very interesting, Mr. Chairman, that it was the State that really got into this and not the Federal. I yield back. It's the chairman's turn.

Mr. DINGELL. The time of the gentleman has expired. The Chair wants to thank the gentleman.

Mr. Hodgman, in your testimony you stated that thousands of people were misled, resulting in the loss of tens of millions of dollars through outright fraud. However you also stated that many of the customers of Lincoln were more vulnerable to being misled regarding the securities they were buying because of the prior relationship they had had with Lincoln.

Could you explain this, please?

Mr. HODGMAN. Certainly, Mr. Chairman. Much is in the scenario painted by the chairman this morning with Rock Solid Bank. A very similar scenario was played out in the branches of Lincoln Savings & Loan.

Many of the investors in the ACC bonds had been long-time customers of Lincoln Savings & Loan. They had grown up in a banking sense with Lincoln from the time when the logo for Lincoln was the Lincoln head profile on the penny.

When Keating took over Lincoln that was transformed into a logo that was virtually identical with that of the parent company, ACC. There was a very strong marketing aspect within the bank in terms of building what Ray Fidel testified to, a Nordstrom's style of customer relations—that is, one that was very customer-oriented, get to know your customer, get to know them on a first-name basis, get to know about their families.

It was this type of relationship that certainly added to the overall tragedy that occurred because it set up the scenario for targeting these very same people for the sale of the bonds.

Mr. DINGELL. That and the abjuration to the sellers of the securities, and I now quote, from .13 that was submitted by Mr. Simon, and remember, the weak, the meek, and the ignorant are always good targets. That right?

Mr. HODGMAN. Yes, sir. In a nutshell, everything that was done in connection with the sale of the bonds, while for the most part in conformity and in adherence to then-existing regulations and laws, was still designed to, say, barely meet the law—that is, barely meet the letter of the law, but not the spirit of the law.

The spirit here was the protection of the consumer. That was not the primary interest that was at the heart of the bond program. The heart of the bond program was to sell, sell, sell bonds, to make money, not to protect consumer interests.

Mr. DINGELL. Now Ms. Hill, Mr. Zipperstein, Mr. Simon, do you all agree with that?

Ms. HILL. I do. Yes, Mr. Chairman, I do.

Mr. DINGELL. I'm sorry?

Ms. HILL. Yes, Mr. Chairman, I do. I do agree with that. The heart of the program was to sell, sell, sell and what we saw in the Federal investigation and in the Federal trial was that lines were occasionally crossed but they, as Mr. Hodgman has said, pushed

the envelope, pushed every regulation they could, to make sure that more bonds were sold and there was obviously tragic consequences to that policy.

Mr. DINGELL. Mr. Zipperstein?

Mr. ZIPPERSTEIN. Mr. Chairman, Ms. Hill speaks for me on all these issues in the Federal case and she is correct.

Mr. DINGELL. Mr. Simon?

Mr. SIMON. I would agree except on I'm not sure I would give the Lincoln Savings crowd as much credit as Mr. Hodgman does for staying within the law or at the edge of the envelope.

I think they did commit a series of violations, while purporting to stay within the rules. They violated almost every rule known to man, but they didn't do anything that was so egregious and so obvious from the outside that they would be shut down quickly.

Mr. DINGELL. Now it is interesting to note, however, that because of the bank exemption they were not required to have bank actions reviewed, for example by the NASD or by the SEC or by any of the Federal regulatory agencies in the areas of securities, is that right, so that they had sort of the privilege of saying things that were misleading but not outright false?

Mr. HODGMAN. Mr. Chairman, I would beg to differ just a little bit. These were securities that were marketed with the auspices and you might say knowledge of the SEC. All of the prospectuses that were utilized in connection with the sale of these bonds were filed with the SEC and as well by adoption with the California Department of Corporations.

I think a very critical point, however, that was a common theme throughout the testimony at trial, perhaps all of our trials, is that the prospectuses were not enough. That is, the paper was not enough to protect the people.

The bond purchasers relied on the verbal representations that were made to them by the bond sellers and this is the key to marketing these bonds and I think it is a fundamental precept of marketing as well: people rely on what they are told, not 45 or 50 pages of fine print.

Mr. DINGELL. Now the prospectus, and I think in all cases, met the requirements of the SEC.

Mr. HODGMAN. The prospectus was duly filed with the SEC. However there is a disclaimer even on the prospectus which states that the SEC does not approve nor necessarily disapprove of what is contained therein. It is simply a matter of filing the prospectus with the SEC.

Mr. DINGELL. I see you want to say something, Mr. Simon.

Mr. SIMON. Don't let me interrupt you.

Mr. DINGELL. No, no, no—go ahead. Had you completed your comment?

Mr. HODGMAN. Yes, sir.

Mr. DINGELL. Now here is the situation though that concerns me. The prospectus meets the SEC requirements. The practices with regard to the securities do not meet SEC requirements because they are exempt. That is, the statements made inside the bank premises are not subject to SEC review or regulation but rather subject to the bank regulators' regulations, is that right? Is that what we're saying?

Mr. HODGMAN. That's my understanding, sir, in connection with the Mellon-Dreyfus situation. They would not be bound by the SEC rules and regulations.

Mr. DINGELL. The SEC has dealt with its requirements with regard to the prospectus. The bank regulators have not dealt with their responsibilities with regard to the oral statements which are made to the purchasers and the other practices which take place inside the bank or in the bank's subsidiary, is that right?

Mr. HODGMAN. As it would seem, sir, yes.

Mr. DINGELL. I beg your pardon?

Mr. HODGMAN. As it would seem.

Another vice here, you mentioned the letters but we didn't talk about it so let me go back to it, is the NASD. These bond salespeople employed by Lincoln and ACC were not registered securities salespeople. They had no training. They had no licenses. They had no license that could be pulled. They had no disciplinary authority that could act on them and that is one of the levels——

Mr. DINGELL. There is no requirement for proper supervision, was there?

Now the SEC would have a requirement for supervision.

Mr. HODGMAN. The SEC or the NASD. I think between the two of them they would cover that quite well.

Mr. DINGELL. And as a matter of fact, those individuals, if they had been functioning under a SEC-regulated entity would have been required not only to be properly supervised but to be licensed broker-dealers or else functioning under the immediate supervision of a licensed dealer, is that not so?

Mr. SIMON. That is precisely correct, and they were not. They were young folks with no background in this at all who were told to go through a canned sales pitch and really had nothing to lose in terms of their credentials. They had no credentials as securities salespeople.

Mr. DINGELL. Well, I think that what both you, Mr. Hodgman, and you Mr. Simon, are telling us is that if we are attempting to insure the customers purchasing money market or other uninsured instruments through banks are informed and understood and that the individual knows what he is purchasing, we have to know what is being said to the customer during the sales pitch, is that right?

Mr. HODGMAN. Yes, sir.

Mr. DINGELL. I think you all agree on that point.

Ms. HILL. Yes, sir.

Mr. ZIPPERSTEIN. Yes.

Mr. DINGELL. You made a comment, Mr. Simon, in your prepared statement which I thought was useful. You said that you had two categories of events here, one being those which were dealt with under bank regulatory process and those which were dealt with under the SEC's security process, is that right? It was early in your statement.

Mr. SIMON. I think I said we had two categories of investors. We had those who simply bought a security from their stock broker and the security happened to be an ACC stock or an ACC debenture of some kind, and on that aspect the case looks no different than any securities fraud.

Mr. DINGELL. Than any other securities fraud case.

Mr. SIMON. And the other is the retail level of fraud—people in Southern California walking into their bank to do one thing and walking out with something entirely different.

Mr. DINGELL. A bait-and-switch operation.

Mr. SIMON. Bait-and-switch. Those people really were subject to two frauds at the same time. They didn't know it, but they were buying a security of a company which had false financial statements but they also were subject to what we have all been talking about the whole morning, which is the bait-and-switch.

Mr. DINGELL. Now the savings and loan was not subject to SEC regulation.

Mr. SIMON. The savings and loan was not but of course the holding company was. Remember that American Continental, a holding company which owned Lincoln and owned a series of other companies, was the actual seller of these subordinate debentures.

Mr. DINGELL. The SEC however had no authority to get in to observe the practices that were going on inside the premises of the SEC, did it—or rather inside the premises of the savings and loan?

Mr. SIMON. I don't know if they had the authority but they certainly didn't do it. The SEC does not as a matter of practice. It's probably a better question for the SEC people, but I have never understood the SEC as a matter of practice to go around and check up on how people sell securities. It has never come across my desk in 19½ years of practicing law that the SEC does testing or checking or spot checking of how securities are sold. That is a matter left to other people.

Mr. DINGELL. Now I think we might view this with some surprise, and if you want to give me your comments, please, any of the members of the panel—what would you say if you learned that neither the FDIC, who provides the insurance, nor the Office of the Comptroller of the Currency, which allows these transactions within banks, use plainclothes testers to go into the bank to determine what is actually being said to the potential customers?

That flows sort of along with what you were telling us just 1 0r 2 seconds ago, Mr. Simon.

Mr. SIMON. I don't think any of them think it is their job. With all due respect, I think they would tell you that that is——

Mr. DINGELL. The SEC's job?

Mr. SIMON [continuing]. Is somebody else's problem. I'm not sure who they would point to but I don't think either the FDIC or Office of the Comptroller would think that was within their role again of protecting the institution rather than the investors.

Remember, these people were treated—the problem here is that these people were treated like investors. They are not the bank. They are not the bank's officers. They are not the bank's depositors.

The day that they got bait-and-switched they became something different. They became investors in the bank——

Mr. DINGELL. So they fell into a category about which the bank regulators thought very little.

Mr. SIMON. That's right and which normally the SEC would think the most. If you analogize it, you most closely analogize it to assume you had a reputable bank or savings and loan in Bethesda, Maryland and they had a holding company which sold stock on the

New York Stock Exchange and you could buy shares of the stock through Merrill Lynch. You might buy 100 shares of stock in the Bethesda National Corporation or something knowing it was a bank holding company or a savings and loan holding company and that would be subject to all of the regulations of the SEC and the Merrill Lynch salesperson who sold those shares to you would be subject to all of the regulations that the NASD, would have to be trained, licensed, supervised—you name it.

What Lincoln did——

Mr. DINGELL. That doesn't change where it's done inside the bank or it's done inside the saving and loan.

Mr. SIMON. It shouldn't change but I think it did change here. I think because it was done inside the savings and loan they were allowed to do it without the appropriate personnel and without the appropriate oversight.

I am not an expert on NASD regulation of brokers but I believe they essentially got around the rules on broker-dealers here by selling them with their own employees and that is really one of the areas of protection that we lost here.

We didn't have a registered NASD representative selling these securities.

Mr. DINGELL. So you are saying an NASD-regulated dealer.

Mr. SIMON. Right.

Mr. DINGELL. Now Ms. Hill, you have been nodding yes. Do you have a comment?

Ms. HILL. Anecdotally I wanted to share with you what we learned about what was happening at Lincoln.

To protect themselves against rumored testers—you had mentioned blind testers coming in to the branches to try to see what the salespeople were stating.

Ray Fidel has told us that there would be rumors that the Department of Corporations would send testers in to the bank to make sure that they were not misleading investors and a notice would be sent to every bond representative to be on good behavior. Attached to Mr. Zipperstein's testimony is a tombstone that appeared right at the teller window for a bank customer to look at regarding an ACC bond. Those would be removed from the branches when there was a rumored tester about to visit. I simply thought the chairman might be interested in the fact that the testers, whether they appeared or not, did not really deter in this case the kind of behavior we have been talking about.

Mr. SCHAEFER. These are company testers you are telling me about?

Ms. HILL. The president of the bank believed that the California Department of Corporations testers would be entering the bank, posing as customers, Lincoln customers, interested in purchasing an American Continental Corporation bond.

To fool the testers they would remove all of the information that was near the teller windows used to lure customers to purchase the ACC bonds. They would essentially clean up their act for a few days and then as soon as they believed the tester had left they would lapse back into the same practices.

Mr. SCHAEFER. Were these testers actually employees of American Continental of Lincoln? Who were they?

Ms. HILL. They were regulators.

Mr. SIMON. They were State of California regulators. So once again the State was involved.

Mr. SCHAEFER. The State was involved.

Mr. SIMON. The State was involved.

Mr. SCHAEFER. But how did these people know ahead of time they were coming?

Ms. HILL. It was rumors. They simply would be preparing—there would essentially be a bulletin shot in the branch saying, "You may be tested." They would, therefore, clean up their act.

Mr. SCHAEFER. There wasn't any indication there was any collusion between the State and the——

Ms. HILL. No, the State would suspect nothing.

Mr. SCHAEFER. Thank you, Mr. Chairman.

Mr. DINGELL. But at that point all the FDIC logos were moved to a more appropriate place?

Ms. HILL. Well, the tombstones were removed that were near the teller windows that shouldn't have been there. It was cleaned up.

Mr. HODGMAN. If I may, Mr. Chairman, just to augment Ms. Hill's anecdote, this is an example of where marketing in the lobbies of the banks or the saving and loans can allow those who operate the banks or savings and loan who are marketing various types of securities to circumvent the testers because one of the central precepts of the marketing program was to get to know your customers.

They knew who their customers were because they were the Lincoln depositors. So in this instance, most of the people, the bond representatives who were selling the bonds, knew who their customer base was. They knew them by sight. They knew them because they had been tellers at the branch.

Furthermore, I seem to recall from some of Mr. Fidel's interviews that when it was removed that the testers would be coming by, the cry went out, "Beware of the suits" because the testers would come in wearing suits and not disguised as normal customers.

Mr. DINGELL. Now, we have talked a little bit about the folks who were dealt with by the savings and loans because there was a desk in the lobby of the bank. But there is nothing to prevent the bankers from saying:

"Now, you don't have to deal with us in the lobby. Just come on down the hall. We have a special little office that is going to give you this wonderful good deal of 1 or 2 percentage points better than you can get in our regular CD by just buying this particular wonderful subordinated debenture"; isn't that right?

Mr. HODGMAN. That is correct, sir.

Mr. DINGELL. You get the same effect because they go in there and they see the same friendly face that they have been dealing with on the other side of the tellers' cage?

Mr. HODGMAN. And as in the case of the ACC/Lincoln, the separate satellite bond office—and I would have to say the orbit of the satellite was never far from the bank itself—the lobby of the satellite bond office would be in an identical decor as with the bank.

Mr. DINGELL. Would it have FDIC logos up, too?

Mr. HODGMAN. No, sir.

Mr. DINGELL. They did?

Mr. HODGMAN. No, sir; they did not.

Mr. DINGELL. They did not.

I'm sorry. Ms. Hill?

Ms. HILL. Mr. Chairman, with regard to moving the sale of the bonds from the branches, that did occur in the Lincoln case in December of 1988. The physical location of the bond sale desk was moved outside the branches.

Initially there was cross selling permitted, that is, allowing Lincoln employees to pump the bonds to Lincoln customers, to direct them to the office down the hall, or around the corner, cross the street, or wherever. That was stopped in the fall of 1988.

As a result of that, it appears that the bond sales dropped dramatically. Once there was no more cross-selling permitted, and once the bond sales were outside the Lincoln branches, the number of purchases by Lincoln customers dropped dramatically.

You should note, however, that during that time Lincoln also showed its first loss, ever. So that may also have deterred customers. But there was a significant drop. That is when Keating instructed his bank president, "Can't we cheat a little?" meaning, "Can't we cross-sell more bonds? Have the Lincoln tellers pump the bonds to our Lincoln customers."

Mr. DINGELL. So they had them pumped from behind the tellers' cage; or what?

Ms. HILL. From anywhere in the branch, essentially, they would be pumping the bonds.

Mr. DINGELL. So business went down, or at least the bond sales went down when they made the real separation?

Ms. HILL. That's correct.

Mr. DINGELL. Then Mr. Keating applied a remedial measure which was to encourage people to pump the bonds, which they did at all places in the bank's facilities?

Ms. HILL. Well, eventually the cross-selling was stopped as well. The bank president believed on the advice of counsel that that should not occur. So, once that happened, there was no more cross-selling. The sale of bonds dropped very, very precipitously.

Then Keating's response to that was to fly all the bond representatives from Southern California to Phoenix, Arizona, have them stay or visit the hotels owned by the parent corporation, and encourage them, as Mr. Hodgman has said, to sell more bonds.

"Sell, sell, sell" was the theme of that meeting. There were two separate meetings in late 1988 for that purpose to try to pump up the sales people to sell more bonds since the sales had been moved outside the branches.

Mr. DINGELL. Now, Mr. Zipperstein, do you agree that the most important element of the transaction is not what is hanging on the wall, or what is in the prospectus, but what is being told to the potential customers in the conversation with this sales person?

Mr. ZIPPERSTEIN. Certainly that was our experience in the Lincoln case; yes, Mr. Chairman.

Mr. DINGELL. That appears to be also the view of Mr. Simon, Mr. Hodgman, and Ms. Hill?

Mr. HODGMAN. Absolutely, so, sir.

Ms. HILL. Yes, sir.

Mr. SIMON. And especially so if the person doing the selling is known to and trusted by the person doing the buying.

Mr. DINGELL. Are you concerned, ladies and gentlemen of the panel, that the Federal regulators currently do not use testers? That certainly brought about a period of momentary good behavior on the part of Lincoln when they thought the testers were coming by?

Mr. HODGMAN. Well, yes, sir. I share that fear and concern. Viewing the Mellon-Dreyfus transaction, I would state this, that I think the regulations that apply in that type of situation have to be front-loaded in a sense, that this body as well as others have to have the strictest possible regulations in place beforehand in order that the consumer, the little guy, does not get harmed.

I would think those regulations would have to include, based upon the lessons of the Keating/ACC/Lincoln tragedy, first of all, a physical separation of the marketing office from the lobbies of the bank, and second, very strict guidelines regarding verbal representations made with regard to the security or whatever it is that is being sold.

With regard to the testers, that is something that obviously has some deterrent effect. Whether we have enough of it to prevent the type of fraud that we have seen here; I don't know, sir.

Mr. DINGELL. Now, Mr. Simon, did your clients tell you that it was the representatives made during the sales pitches and not the information in the prospectus or other written information that gave them their basic understanding of the transaction?

Mr. SIMON. Yes, sir.

Mr. DINGELL. Mr. Hodgman, tell us what you think has gone wrong here? How do we protect consumers if the art of the deal is in the conversation between the salesman and the potential customer?

Mr. HODGMAN. Mr. Chairman, as I have stated, the paper is not sufficient to protect the people. The prospectus is simply not enough. Even in the Keating example where on the face of the prospectus it was stated that these securities were not insured, the bond purchaser never had a clear understanding of that.

More often than not, the bond purchaser who testified at trial, or who was interviewed would state that they did not rely upon the prospectus, they relied upon what they were told. That is why I would assert to you and to the subcommittee that you have to have the strongest possible guidelines and regulations in place up front before any type of merger of a Mellon or a Dreyfus or anything else that may come on down the road be approved.

Mr. DINGELL. Now, what are you thoughts on that, Ms. Hill, Mr. Zipperstein, and Mr. Simon?

Mr. ZIPPERSTEIN. Mr. Chairman, as Federal prosecutors in a U.S. Attorney's office, we are somewhat reluctant to suggest policy or legislation.

We want the community of businessmen/would-be Keatings who come into our District, the largest Federal district in the country in terms of population, to know that if they break the laws that this Congress passes, that we will prosecute them and we will put them in jail.

Ms. HILL. I simply would point out to the subcommittee that, in fact, right on the prospectus it said on the last page—and we have attached a copy of that prospectus—it said that no oral representations were to made, or if they were made, they should not be relied upon by the purchaser.

It is in bold type right on the back page. But it was, in fact, true, we found, as Mr. Simon and Mr. Hodgman have stated, that most people relied on that relationship, the trust that they had and the oral statement, "This is as safe and secure as Lincoln. It is backed by Lincoln's assets."

Mr. DINGELL. Mr. Simon?

Mr. SIMON. Mr. Chairman, I think you probably have to deal with structures and atmospheres more than try to regulate what is said. I think it is almost impossible to regulate what thousands of people say to tens of thousands to others.

You can demand training. You can demand licensing. You can demand supervision. That is one level of regulation that we did not have here given the people who were selling the bonds. You can physically separate the two sales areas. You can make the names different. You can make the logos different. That is what I mean by structure and atmosphere.

It seems to me that sitting in Washington trying to write legislation or pass regulations to govern the entire problem coast-to-coast, the best thing you can focus on is structure and atmosphere. What basic minimum protections can we put in so that the bulk of the people who buy a Dreyfus mutual fund or something else like that understand that it is a Dreyfus mutual fund and do not believe that it is a deposit in the Mellon Bank. That is where I would focus my attention is on structure and atmosphere which was at its worst in Lincoln.

Mr. HODGMAN. Mr. Chairman, if I might add, the reason we need to have strict regulations on that structure and atmosphere is because it is too late for the victims, for the human victims for someone like myself to bring a criminal prosecution after the fact, or for the Federal Government to bring a criminal prosecution after the fact, or for Len Simon and his associates to bring a class action law suit.

This scenario was indeed a tragedy. If the subcommittee could hear the testimony of even one representative bond purchaser, it would be a plaintiff cry for "Protect the consumer." The reason is it takes time for agencies and institutions to rectify the situation like ACC/Lincoln.

Just to take one example, there was a victim who testified at our trial, at the State trial, named John Bruner. John Bruner flew fighter planes in World War II. After World War II he and his wife became puppeteers.

They toured California and the American Southwest giving puppet shows to children. This is where they made their money. They saved what money they could for their nest egg when they retired. They did not have 401(K)s. They were independent contractors. They needed that nest egg.

Mr. and Mrs. Bruner relied upon what they were told in the lobby of Lincoln Savings and Loan about the ACC bonds, that they were safe and secure. In reliance upon those representations, they

took their nest egg, put it in the ACC bonds, and then in April of 1989 found out that they were wiped out, that they had no money there.

Now, it is almost 5 years later, and through the efforts of Mr. Simon, the Bruners have achieved partial recovery. But for Mr. Bruner, someone who suffered a long and lingering illness, and who died just about a year ago, he had to live out the remaining years of his life without financial security, operating on a tight rope where every day it was a choice between spending too much and really going into the hole, or getting by. He died after this illness not knowing that his wife would ever get all the money back, that his wife would be secure.

This is what this type of tragedy in ACC/Lincoln meant to individual people. That type of scenario was replicated thousands of times in this case. That is what we need to be mindful of as we proceed.

Mr. DINGELL. And it could happen again unless we extended the securities protections to deal with the behavior of bank employees and officers who are, at this minute, exempt from the regulation of the SEC; isn't that right?

Mr. HODGMAN. That's my fear; yes, sir.

Mr. DINGELL. And, of course, that would necessarily include talking about mutual funds being sold out of banks. The same opportunity is there because you can talk about subordinated debentures or you can talk about a mutual fund which, for example, deals in a series of speculative types of securities; isn't that right?

Mr. HODGMAN. Yes, sir.

Mr. DINGELL. Do any other members of the panel have any comments on that matter?

[No response.]

Mr. DINGELL. Let me address, ladies and gentlemen, then, the situation here. I think we have talked then about a consumer who thinks he is buying something that he really is not buying. He never questions the nature of the investment, or if he does, he is given essentially dissembling information.

When he is asking questions, he is given misleading information, for example, that FDIC insurance versus SIPC insurance is going to be his protection, or that SIPC insurance goes beyond what he really, in fact, is getting.

Now, what are your comments on that matter? You made some comments, Mr. Hodgman, but we would be glad to hear additional comments you might want to make on that.

Mr. HODGMAN. I think the only additional comment that I would like to make, sir, is that the specter of the tragedy that occurred with ACC/Lincoln has not died and it could very well be present in a merger such as the one the subcommittee is contemplating.

Mr. DINGELL. Do the other members of the panel have a comment? Ms. Hill, Mr. Simon, Mr. Zipperstein?

Mr. SIMON. I think the word "insurance" is really a dramatic and an important word in this area. It is probably something that the subcommittee should keep its eye on. I think playing a shell game with FSLIC insurance versus SIPC insurance, which I discussed earlier, or again this issue of "Will you allow uninsured instru-

ments to be sold under the roof of what appears to be an insured institution?" is really a crucial consumer protection issue.

It is what cost my clients their money. I am not sure even that SEC regulations is going to cure the problem as much as simply separating banks from nonbanks and making it clear to anybody who walks in the door of the institution they are in that they are in a bank which takes deposits or they are in some other entity—they are in K-Mart, or Sears, or Merrill Lynch or some other place—and they are doing an entirely different kind.of transaction.

All the SEC can do, really, is go in after the fact. They can pick up the pieces. They can sue people. They can try to refer them to the U.S. Attorney, or we can sue them for money. But at the front end, I think a separation of the two types of instruments is very important.

Mr. DINGELL. I think I agree with you.

Now, ladies of the gentlemen of the panel, we have a continuum of public policy options here. On one end we can allow more and more banks to enter the securities field, leaving more and more customers open to transactions which possibly have the situation that we have seen in the Lincoln Savings and Loan and with customers vulnerable to transactions they may or may not be able to understand.

On the other extreme, we could attempt to roll back the practices of banks selling and marketing securities because of concerns of consumer protection, or we could come in somewhere in-between where we allow existing transactions to continue but put a moratorium on expanding the business while we aggressively move towards plugging the consumer protection gaps.

From what you have seen in the Lincoln case, what do you believe would be the prudent public policy option for the Congress to exercise?

Mr. HODGMAN. Mr. Dingell, to continue a metaphor that was utilized earlier this morning, I believe it is time to shut the door to the barn. Maybe a few horses have gotten out, but for the remainder, they should be kept in the barn. For those who are running free in the fields right now, they should be looked at very closely by the appropriate regulatory agencies, and I believe the sort of ombudsmen regulation that this subcommittee and the chairman is considering is very important.

So I come down very strongly on the side of consumer protection in this instance because I have seen what happens when consumer protection interests are left in the dust.

Mr. DINGELL. Ms. Hill?

Ms. HILL. Mr. Chairman, I would comment that I believe Charlie Keating appreciated the fact that there was an opportunity to sell an uninsured product in an insured environment. He took advantage of that.

The reason that I know that he knew that this was a good opportunity for him was he referred to it as cheap money. He took the money from Mr. Simon's clients and used that to pay off debt that he had with more senior debt at institutional investors, that institutional investors held—junk bonds that Drexel had issue on behalf of ACC.

He used the little old ladies' money to pay off that debt. The reason he did that was because he could sell the junk bonds in the Lincoln branches for a lower interest rate. It was cheap money for him. He knew that he could do that because of the confusion between whether it is an insured product or an uninsured product.

The little old ladies, as Mr. Simon has said, would never have bought, the retirees would never have purchased these bonds if they had understood that they were junk bonds—risky, so risky that institutional investors, sophisticated investors, demanded a higher interest than Keating was willing to pay.

So, the lesson that I have drawn from that is that at least in the Lincoln environment, the blurring benefitted Charlie Keating. It allowed him to keep his operation in operation for far longer.

Mr. DINGELL. Mr. Zipperstein?

Mr. ZIPPERSTEIN. Mr. Chairman, I would just accept Ms. Hill's statements and adopt them as my own, with your permission.

Mr. DINGELL. How about it, Mr. Simon?

Mr. SIMON. I think Ms. Hill and Mr. Hodgman have covered it quite well.

Mr. DINGELL. Well, you have helped us greatly. I want to express my personal gratitude to each of you and also that of the subcommittee. You have come a long way, all of you, to assist us. We know that you have done it at some substantial personal sacrifice. I want you to know that the committee is grateful to all of you for your assistance today.

Thank you very much.

Mr. ZIPPERSTEIN. Thank you, Mr. Chairman.

Mr. SIMON. Thank you.

Mr. HODGMAN. Thank you.

Ms. HILL. Thank you.

[The following information was subsequently submitted by the subcommittee:]

SEC v. Charles H. Keating Jr., et al.
Civil No. 91-6785, Central District of California

1. What does the SEC's Complaint allege?

This matter concerns the fraudulent sales practices used in the offer and sale by American Continental Corporation ("ACC") of subordinated debentures ("bonds") in the lobby of its subsidiary, Lincoln Savings and Loan Association ("Lincoln"), and in offices near Lincoln. It also involves false and misleading financial statements and disclosures in the ACC prospectus used to sell the bonds and in periodic filings with the Commission. Keating also is charged with engaging in insider trading in connection with sales of his ACC stock. Defendant Keating and four others currently are scheduled for trial on May 12, 1994.

2. What were ACC and Lincoln?

ACC, which filed for bankruptcy in April 1989, was a financial services and real estate development firm headquartered in Phoenix, Arizona. Lincoln, a wholly-owned subsidiary of ACC, was a California-chartered savings and loan association based in Phoenix and Los Angeles, California. On April 14, 1989, the Federal Home Loan Bank Board placed Lincoln in conservatorship. In August 1989, Lincoln was placed in receivership. Currently, the RTC is in the process of liquidating Lincoln's assets.

3. What were ACC bonds?

ACC bonds were high risk "junk bonds" which were subordinate to virtually all of ACC's debt. ACC offered and sold $275 million in bonds during the period from December 1986 through mid-February 1989 at interest rates ranging from 8 3/4% to 12 1/2% and maturities ranging from one to ten years. Approximately $220 million of the bonds were outstanding when ACC filed for bankruptcy. ACC sold the bonds in part to retire more senior debt which paid higher interest rates.

4. Who sold the ACC bonds?

From December 1986 through approximately August 1989, the bonds were sold by ACC bond representatives in the lobbies of Lincoln branches. Beginning in August 1989, the bonds were sold in small ACC offices near the Lincoln branches. Most or all of ACC bond representatives were former Lincoln employees. The bond representatives were supervised by Lincoln employees. The bonds were self-underwritten by ACC, and most of the bond representatives were not registered to sell securities.

5. What types of sales tactics were used?

ACC bond representatives and Lincoln branch managers and tellers engaged in a program of "cross-selling" the bonds. As part of the cross-selling program, the bond representatives and Lincoln employees publicized the bonds within Lincoln branches. They placed brochures and posters at various locations throughout the branches, including on the teller lines or counters and in the branch windows. In addition, on at least one occasion, they printed promotional information concerning the bonds on Lincoln monthly checking account statements. The bond representatives and Lincoln employees solicited Lincoln customers to purchase the bonds by making telephone and mail solicitations to Lincoln customers who held maturing CDs and to new Lincoln customers. Some Lincoln customers received letters soliciting bond purchases on Lincoln stationery. To encourage cross-selling, ACC and Lincoln operated a bonus program whereby the bond representatives and Lincoln branch employees received bonuses if the branch met a predetermined sales quota.

6. Were the Bonds Confused with CDs?

The practice of cross-selling misled some bond purchasers to believe that the bonds were instruments of Lincoln or were otherwise insured by the FDIC. Bond representatives and Lincoln employees made false and misleading representations which could have led bond purchasers to confuse the bonds with CDs. Specifically, the bond representatives and Lincoln employees falsely represented that the bonds were insured or were as safe as CDs; that the bonds were safe, riskless or low risk; and that the bonds were secured or otherwise backed by the assets of Lincoln and/or ACC.

7. Was ACC's payment of bonuses illegal?

Although the bonuses were not per se illegal under the securities laws, the prospectus specifically represented that the bonds would be sold only by ACC employees and that they would not receive compensation based on sales. In addition, as a consequence of the bonus payments, ACC, Lincoln and the employees involved in the sales were not eligible for an exemption from the broker-dealer registration requirement.

8. What were investors told about the risk involved with purchasing bonds?

The bond representatives and Lincoln employees falsely told customers that the bonds were insured or were as safe as CDs; that the bonds were safe, riskless or low risk; and that the bonds were secured or otherwise backed by the assets of Lincoln and/or ACC.

9. **Were other false or misleading statements made during the offer and sale of the notes?**

ACC provided to investors and the public false and misleading financial statements which materially overstated its earnings by approximately $120 million over a three and one-half year period. In addition, ACC made false and inadequate disclosures in ACC's filings with the Commission about ACC's liquidity, cash flow, related party transactions and due diligence procedures.

10. Did the prospectus disclose that the bonds were not insured by the FDIC?

Yes. The prospectus stated on the front cover that the bonds were not insured by the FDIC.

11. Against whom did the Commission file suit in this matter?

On December 12, 1991, the Commission filed a civil injunctive action against:

Charles Keating Jr., former Chairman and President of ACC.

Charles Keating III, former Executive Vice President of ACC and Chairman of the Board of Lincoln.

Judy Wischer, former President and Chief Operating Officer of ACC, and former Chairman of the Board, Chief Executive Officer, and President of Lincoln.

Andrew Ligget, former Chief Financial Officer of ACC and director of Lincoln.

Robert Kielty, former Senior Vice President, Secretary and General Counsel of ACC and director of Lincoln.

Robert Wurzelbacher, Jr., former Senior Vice President and director of ACC.

Jack Atchison, former Senior Vice President of ACC.

James Upchurch, ACC employee.

Mark Sauter, former in-house attorney for ACC.

David Paul, former Chairman and Chief Executive Officer of CenTrust Savings Bank, a savings and loan institution that was based in Miami, Florida.

Defendants Wischer, Ligget, Wurzelbacher, Sauter and Paul, without admitting or denying the allegations in the complaint, have consented to the entry of permanent

injunctions against future violations of certain provisions of the federal securities laws.

In separate actions, the Commission filed settled injunctive actions against four other former officers of Lincoln and ACC, Bruce Dickson, Ray Fidel, Robin Symes, and Dariush Razavi, and a former business associate of Keating Jr., Ernest Garcia II.

12. What are the lessons to be learned from the sale of ACC debentures at Lincoln?

The first lesson to be learned is that the sale of uninsured securities to customers of financial institutions creates a situation that is fraught with risk. Despite the best of disclosures and the cleanest of sales practices, financial institution customers have a sense of safety and security that is inextricably linked to the institution, and may be extremely difficult to break. Therefore, if such sales are allowed to take place, they must be subject to the utmost care so that even the best-intentioned issuer or sales staff does not inadvertently reinforce this linkage or simply fail to disabuse the customer of his or her predisposition to believe that anything offered by or at the financial institution is safe.

The second lesson to be learned is that marketing plans that look reasonable and fair on paper may not be so in application. ACC represented to regulators that it had a strong wall in place -- literally as well as figuratively, in some instances -- to isolate the debenture sales from the operations of the savings and loan. In reality, the wall barely existed, and was frequently breached. Any involvement of the financial institution or its personnel, even the placement of marketing materials or the simple referral of customers to the securities salesperson, can easily lead to misunderstanding on the part of customers. Lincoln may be the extreme example of lack of restraint, but even lesser breaches of the wall can have unfortunate effects.

The third lesson is that incentives to financial institution personnel to "cross-sell" securities multiplies the risk. This lesson is not limited to payment of commissions or financial compensation tied directly to particular sales or sales goals. Any recognition of cross-selling or marketing efforts on the part of tellers or other personnel, or even a generalized belief on their part that their careers will be enhanced by helping to market securities can tempt the financial institution employees, who are not trained in the sale of securities or suitability requirements, to step over the line to the potential detriment of their customers.

Mr. DINGELL. The Chair announces that our third panel is Ms. Denise Voigt Crawford, Securities Commissioner for the State of Texas, and Chair of the Banks Securities Activities Committee of the North American Securities Administration Association from Arlington, Virginia, and Ms. Lena Archuleta, a member of the Board of Directors of the American Association of Retired Persons.

They will be accompanied by Ms. Diane Colasanto, and Mr. Chris Lewis. Ms. Colasanto is President, Princeton Survey Research Associates in Princeton, New Jersey, and Mr. Lewis, Director of Banking and Housing Policy, Consumer Federation of America, Washington, D.C.

Ladies and gentlemen, thank you for being with us today. We regret that we have kept you waiting here so long. But we know that you appreciate the fact that we have to go through a certain amount of time before we complete our business with any of the panels.

We certainly want you to know that we feel that your testimony is very important. We want to hear it with the same concern that we have listened to our witnesses this morning.

Having said that, ladies and gentlemen, you are aware of the fact that it is the practice of the committee that the committee testify under oath. Do any of you object to testifying under oath?

[Chorus of nos.]

Mr. DINGELL. The Chair advises that you are entitled that if you testify under oath, to be advised by counsel. Do any of you desire to be so advised?

[Chorus of nos.]

Mr. DINGELL. The Chair advises that copies of the rules of the committee, rules of the subcommittee, rules of the House are there to advise you on your rights as you appear here and also the limitations on the powers of the subcommittee.

If you then have no objection to testifying under oath, would you each please rise and raise your right hand.

[Witnesses sworn.]

Mr. DINGELL. You may each consider yourself under oath. We will hear from you commencing first with Ms. Crawford, then Ms. Archuleta, and then finally Ms. Colasanto and Mr. Lewis in that order.

You may proceed with the thanks and the appreciation of the committee.

TESTIMONY OF DENISE VOIGT CRAWFORD, CHAIR, BANKS SECURITIES ACTIVITIES COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION; LENA ARCHULETA, MEMBER, BOARD OF DIRECTORS, AMERICAN ASSOCIATION OF RETIRED PERSONS, ACCOMPANIED BY DIANE COLASANTO, PRESIDENT, PRINCETON SURVEY RESEARCH ASSOCIATION; AND CHRIS LEWIS, DIRECTOR OF BANKING AND HOUSING POLICY, CONSUMER FEDERATION OF AMERICA

Ms. CRAWFORD. Mr. Chairman, good afternoon. I am the Texas Securities Commissioner. My name is Denise Crawford.

I am here today on behalf of the North American Securities Administrators Association, which for short is known as NASAA. In

the United States, NASAA is the National Association of the 50 States' securities regulatory agencies around the Nation.

I very much appreciate the opportunity to appear before the subcommittee to comment on the very serious consumer protection issues that arise from the sale of uninsured investment products on banks premises.

Today, State security regulators across the country are reporting mounting evidence of consumer confusion about the lack of insurance coverage and the risk and fees associated with the sale of uninsured products sold at banks.

An informal look by several States of what is actually going on in bank lobbies makes it very clear why consumers are so confused. The market place is sending them a bewildering array of mixed, garbled, and misleading messages.

Among the problems uncovered by States of the banks were a blurring of the distinction between traditional bank activities and the sale of uninsured products, inadequate or misleading disclosure about FDIC and SIPC insurance coverage, and finally a serious gap in the consumer protection available to those who purchase securities on bank premises.

A more comprehensive look at the ramifications of this issue on the individual level may be found in the National Opinion Survey released in January by NASAA and the AARP. What this survey revealed was that fewer than one in five bank customers knows that mutual funds and annuities are not insured by the FDIC.

That survey also found that a substantial number of Americans are unsure about the risks involved in such investments sold at banks. They are not questioned about the appropriateness of these investments for their needs, and they are unaware of where to turn for regulatory help in the event they have a problem with an uninsured investment product purchased at a bank.

We know what happened with the outpouring of consumer panic and distrust in the wake of 1987's Black Monday. At that time most of the backlash was focused against brokerage firms and investment companies.

Now banks have opened themselves up to the same reaction from the public. As a result, this is more than just a matter of concern for the consumer. This is something that has the potential to emerge down the road as a real test of the public's perception of the safety and soundness of banks.

NASAA has made available at no cost to the public a consumer tip sheet that is designed for bank customers contemplating the purchase of an investment product. This simple English document sets out the facts about the issues where the NASAA/AARP survey shows that bank customers are most confused. I have a copy of this tip sheet with me today and would ask that it be made a part of the hearing record.

Clearly the time has come for Federal legislation to comprehensively address the issues of securities activities conducted on bank premises and the safeguards that are needed to protect investors. It is abundantly clear that banks already are in the securities business in a major way.

The proposed Mellon-Dreyfus merger serves to underscore and bring into focus the concerns expressed by NASAA and its mem-

bers about the steadily increasing role of banks in the securities markets at a time when there are no legally mandated investor safeguards.

The fact is that the laws and regulations governing the activities of financial institutions simply have not kept pace with the dramatic changes in the market place. While there may have been many serious efforts over the years to rationalize the oversight of the new bank activities, we nonetheless are left today with a regulatory system that defies common sense. It is wholly inadequate, and potentially could result in a serious and devastating loss of consumer confidence.

There can be no doubt that the existing statutory framework is woefully outdated. It is not up to the demands of a rapidly changing marketplace.

Others who have testified before me today have provided you with an excellent overview of the shortcomings of our current laws. NASAA joined with the AARP and the Consumer Federation of America, CFA, to develop the following minimum standards for reform legislation in this area.

One, mandatory use of disclosure that is proven to work.

Two, a ban on naming or advertising uninsured bank products in any way that creates confusion with insured bank products or the institution itself.

Three, no gap in the consumer protection available to bank customers buying investment products.

And, four, a mandatory physical separation of the sale of insured and uninsured products within banks.

NASAA is very pleased to lend its strong support for H.R. 3447, the Securities Regulatory Equality Act. This legislation would provide for the functional regulation of bank securities activities and thus close the consumer protection gap that now exists.

Our outmoded regulatory system has forced most securities regulators for definitional and jurisdictional reasons to watch from the sidelines as banks become more and more active in the securities marketplace. The continued exclusion of banks from the definitions of "broker," "dealer," and "investment adviser" serves no public interest. And, to the contrary, means that banks need not comply with the consumer protection, net capital, and books and records rules that were specifically designed to protect investors.

Mr. Chairman and members, NASAA respectfully urges Congress to move swiftly to adopt H.R. 3447 and to ensure that this Nation's financial system is one that inspires confidence on behalf of consumers and operates as efficiently and safely as possible.

Thank you.

[Testimony resumes on p. 198.]

[The prepared statement and attachment of Ms. Crawford follow:]

STATEMENT OF
DENISE VOIGT CRAWFORD

on behalf of the
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

My name is Denise Voigt Crawford. I am Securities Commissioner for the state of Texas and chair of the Banks Securities Activities Committee of the North American Securities Administrators Association (NASAA), on behalf of which I appear here today. In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

I appreciate the opportunity to appear before the Subcommittee on Oversight and Investigations to comment on the very serious consumer protection issues that arise from the sale of uninsured investment products on bank premises[1]. As you are well aware Mr. Chairman, the primary function of state securities regulation is the protection of small investors from fraud and abuse in the capital markets. As a result, we see the day-to-day implications of what at times may be thought of on the national level only in theoretical terms, or worse yet, dismissed as mere "turf battles."

Today, state securities regulators across the country are reporting mounting evidence of consumer confusion about the lack of insurance coverage, and the risks and fees associated with the sale of uninsured products sold on bank premises.[2] An informal look by several states at what is actually going on in bank lobbies makes it very clear why consumers are so confused: the marketplace is sending them a bewildering variety of mixed, gobbled and misleading messages. Among the problems uncovered by states at the banks were: a blurring of the distinction between traditional bank activities and the sale of uninsured products; inadequate or misleading disclosure; and a serious gap in the consumer protection available to consumers who purchase securities on bank premises.

A more comprehensive look at the ramifications of this issue on the individual level may be found in the national opinion survey released in January by NASAA and the American Association of Retired Persons (AARP). What this survey revealed was that the vast majority of American bank consumers are unaware of the risks and fees involved in the uninsured investment products, such as mutual funds and annuities, that are now increasingly available at U.S. banks and other financial institutions. The survey data indicate that fewer than one in five bank customers knows that mutual funds (18 percent)

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[1] For purposes of simplification, the term "bank" is used throughout this testimony to refer to financial institutions generally, including thrifts, savings and loan associations and credit unions.

[2] This is not to say that NASAA is opposed to the sale of uninsured products on bank premises. In fact, it is the Association's position that banks are now another option for consumers who have money to invest mutual funds, stocks and annuities and understand the risks in doing so. Our goal is to make sure that there is no "consumer protection gap" in relevant regulation.

and annuities (14 percent) are not insured by the Federal Deposit Insurance Corporation (FDIC). The survey also found that a substantial number of Americans are: unsure about the risks involved in such investments sold at banks; not questioned about the appropriateness of these investments for their needs; and unaware of where to turn for regulatory help in the event they have a problem with an uninsured investment purchased at a bank.

What state securities regulators see in these numbers is a distressing pattern of confusion and false comfort on the part of bank customers, a very substantial portion of whom do not seem to grasp the fact that banks have moved beyond its narrow and traditional business of selling only FDIC-insured products. When the next market correction takes place, millions of U.S. consumers may end up learning the hard way that there is no safety net for mutual funds and stocks sold at banks.

We know what happened with the outpouring of consumer panic and distrust in the wake of 1987's "Black Monday." At that time, most of the backlash was focused against brokerage firms and investment companies. Now banks have opened themselves up to the same reaction from the public. As a result, this is more than just a matter of concern for consumers; this is something that has the potential to emerge down the road as a real test of the public's perception of the safety and soundness of banks.

It is NASAA's view that the time has come for federal legislation to comprehensively address the interrelated issues of securities activities conducted on bank premises and the safeguards needed to protect investors. It is abundantly clear that banks already are in the securities business in a major way. The proposed Mellon/Dreyfus merger serves to underscore and to bring into focus the concerns expressed by NASAA and its members about the steadily increasing role of banks in the securities markets and the lack of legally-mandated investor safeguards. This is a situation that simply cannot be allowed to go on in an "ad hoc" fashion.

The simple fact is that the laws and regulations governing the activities of financial institutions have not kept pace with the dramatic changes in the marketplace. While there have been many serious efforts over the years[3] to rationalize the oversight of the new bank activities, we nonetheless are left today with a regulatory system that defies common sense, is wholly inadequate, and potentially could result in a serious and devastating loss of consumer confidence. NASAA respectfully urges Congress to move swiftly to ensure that this nation's financial system is one that inspires confidence on behalf of consumers and operates as efficiently and safely as possible.

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[3] NASAA would like to take this opportunity to commend Chairman Dingell and other Members of the Energy and Commerce Committee for the leadership role you have played over the years in focusing attention on the shortcomings of the current regulatory system and for your unflagging dedication to prudent regulation.

NASAA supports the adoption of legislation, such as H.R. 3447, that recognizes the special circumstances that arise when uninsured products are sold at banks that have spent many decades persuading consumers to trust them because of the FDIC protection available for their traditional deposit products. At the same time, we would urge federal banking regulators to proceed cautiously and to exercise restraint with respect to allowing new investment-related activities on bank premises before the appropriate investor safeguards are put in place. The status quo of inconsistent and ad hoc application of investor protection standards simply is not acceptable.

THE EROSION OF GLASS-STEAGALL BARRIERS

The issue of whether commercial banks should be allowed to tap into new sources of business, including the sale of uninsured products on bank premises either directly or indirectly, is no longer an academic question. The fact is that many of the restrictions on the securities activities of banks erected by the Glass-Steagall Act[4] have been eroded or removed through judicial and administrative decisions[5], thereby allowing banks and their non-bank affiliates to participate in a broad range of uninsured investment-related activities.

The regulatory and court decisions creating loopholes in the Depression-era law banning banks from the securities business have been in place for several years now. But it has only been recently that low interest rates have prompted the explosive growth in the sale through banks of uninsured products. As these low interest rates have propelled consumers to search beyond traditional bank savings products for better returns, more and more banks have moved to offer their clientele a wider range of financial products. Mutual funds, popular with consumers for a number of reasons, are one of the investment alternatives that many banks are providing in their bid to retain customer assets and generate new sources of revenue.

Banks are now major participants in the securities markets and it is likely that their involvement will continue to grow as bank customers move away from insured deposits into mutual funds and other uninsured products. Today, about one-third of all mutual

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[4] Banking Act of 1993, 48 Stat. 162-95 (codified as amended in various sections of 12 U.S.C.).

[5] For example, the Office of the Comptroller of the Currency has used the "incidental powers" clause of the National Bank Act to allow national bankers to engage in certain activities once considered the exclusive territory of investment and insurance firms. The Federal Reserve has used the "closely related" language of the Bank Holding Company Act to expand the permissible product and service lines for bank holding companies.

funds are available through the bank channel.[6] Why are banks expanding beyond their traditional base and moving into recommending or selling to retail customers non-deposit investment products, such as mutual funds and annuities? It may be because selling investment-related products can be a profitable business and, significantly, a growth business at a time when banks are suffering a steady erosion in their traditional product lines. Banks are not only anxious to retain customers in search of higher returns, but they also are eager to tap into the growing consumer demand for mutual funds and other investments.[7]

While mutual funds may be the investment product of choice today, we should not assume that banks will limit their activities to such a narrow range of new activities. The proposed Mellon-Dreyfus merger is a recognition of the new levels to which banks may get involved in uninsured activities. Nor should we dismiss concerns about the potential for consumer harm based on the fact that banks are now involved in the sale of uninsured products due primarily to mutual fund activity. As one industry observer so aptly cautioned, " ... the 'rising tide' in mutual fund sales has masked the fact that the mutual fund business is not immune from downturns ... .[8]" I can't help but wonder what we would be facing today in terms of a banking crisis if banks had gotten into the securities business a decade ago when the "hot" investment product was limited partnerships, which at the time were thought of by investors as good, relatively safe, stable long-term investments and have since gone sour on a colossal scale.

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[6] "Fundamentals," Mutual Fund Research in Brief, Research Department, Investment Company Institute, May 1993.

[7] For example, according to data gathered for Money magazine's "Small Investor Index," from January 1, 1993, to November 1, 1993, bank depositors reportedly withdrew about $77 billion from certificates of deposit and reinvested most of the proceeds in stock and bond mutual funds. (Jordon Goodman, "Depositors Switch Billions from CDs to Mutual Funds," Money, December 1993.) To be sure, not all of the money going into bank mutual funds is coming from maturing CDs. In fact, money from maturing CDs accounted for only about 5.5 percent of the individuals who invested in stock or bond mutual funds from July 1991 to July 1993. The bottomline is that the money flowing into mutual funds is coming from more sources than just maturing CDs. (Stan Hinden, "Some Wrongs That Have Become Rites," Washington Post, November 17, 1993, p. G3.)

[8] Matthew Fink, Investment Company Institute, "Rough Weather Ahead for Banks in Mutual Funds," American Banker, February 17, 1994, p. 29.

THE SALE OF UNINSURED PRODUCTS ON BANK PREMISES: THE BIGGEST CONSUMER AWARENESS PROBLEM IN AMERICA TODAY?

It was late last summer when NASAA and the American Association of Retired Persons (AARP) first discussed the need to gather additional information about what appeared to be widespread customer confusion concerning the sale of uninsured investment products on bank premises. We agreed that in order to formulate specific policy recommendations, we would need to know more about the level of consumer understanding of the risks involved in purchasing uninsured products through banks and more about how it is that banks are conducting their investment-related activities.

What we found in a nationwide survey is that the vast majority of American bank customers are unaware of the risks and fees involved in the uninsured investment products, such as mutual funds and annuities, that are now increasingly available at U.S. banks and other financial institutions.

<u>Key Survey Findings</u>

The survey released on January 13, 1994, by the American Association of Retired Persons and the North American Securities Administrators Association was conducted by Princeton Survey Research Associates of Princeton, New Jersey. The results were based on telephone interviews with a representative sample of 1,000 adults living in the United States who reported making financial decisions for their household and also reported using a regular commercial bank.[9] One quarter of the commercial bank customers also use a mutual fund company and one in five (21 percent) use a brokerage company.

Major results of the NASAA/AARP survey include the following:

o **The vast majority of bank customers are unaware that mutual funds, stocks and annuities sold at their banks are <u>not</u> insured by the FDIC program.**

> Fewer than one in five commercial bank customers understands that mutual funds (18 percent) and annuities (14 percent) are <u>not</u> FDIC insured.
>
> Only one quarter (25 percent) of customers at banks where stocks are sold know that these products are uninsured.

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[9] Interviews for the NASAA/AARP survey were conducted during the period October 14-October 31, 1993. The margin of error for the total sample of 1,000 commercial bank customers is plus or minus 3 percentage points at the 95 percent level of confidence. The margin of sampling error for results based on a subset of the total sample is larger.

About two in five customers think mutual funds (39 percent) and annuities (40 percent) sold at banks are FDIC insured. Another 43 percent don't know whether such mutual funds are insured, and 46 percent are unsure whether annuities sold at their banks are insured.

A third (35 percent) of the customers at commercial banks where stocks are sold think these purchases are FDIC insured, and another 40 percent are unsure.

o **People who have actually purchased mutual funds or annuities at their bank are no better informed about the risks associated with such investments than are other bank customers.** In fact, these purchasers are even more likely than other bank customers to think the FDIC program covers their investment in a mutual fund or annuity sold at a bank.

About half of the people who purchased a mutual fund (52 percent) or annuity (55 percent) at a bank think the purchase was FDIC insured. This compares to 39 percent and 40 percent of all bank customers who think mutual funds and annuities sold at banks are FDIC insured.

Over a third of those who purchased a mutual fund (36 percent) or an annuity (38 percent) at a bank say no one talked with them about the appropriateness (or "suitability") of their investment.

o **Most people who have purchased mutual funds at their bank are also confused about the costs and fees associated with these investments.**

Only 36 percent of mutual fund buyers think they pay a front-end sales load, even though many mutual funds sold through banks involve such a charge.

More than half (54 percent) either believe that there is no redemption fee associated with their mutual fund or are uncertain about the applicability of such a fee in relation to their investment.

In general, a quarter to a third of all those buying mutual funds at a bank do not know if there is a front-end sales load, redemption fee or other management cost associated with their mutual fund.

o **So, even though banks provide their customers with written disclosure documents about uninsured investments, the material is apparently not effective in communicating important details about the risks and costs of these investments.**

Most purchasers of mutual funds (85 percent) and annuities (63 percent) sold at banks say their bank provided them with a disclosure document about their investment.

Most who remember receiving this information also remember taking the time to read it (86 percent of mutual fund buyers and 77 percent of annuity buyers).

- **Bank customers trust their banks and rely upon them to provide good information.**

  Almost nine out of ten (88 percent) bank customers feel they have always received accurate information from their banks about the risks of investing. Only 4 percent believe that they have been misled or misinformed.

  Only 5 percent would contact a government agency for help in resolving a problem with an uninsured investment purchased through a bank. Most (82 percent) would try to resolve the problem by contacting someone at the bank.

- **Bank customers admit they are less secure in their understanding of the risks in investments than they are about other details of banking.**

  Large majorities say it is easy to understand the fees and rates their bank charges (82 percent) and the regulations that apply to different bank accounts (75 percent).

  However, considerably fewer bank customers (57 percent) say it is easy to understand the financial risks involved in making different kinds of investments through their banks.

- **Uninsured investment products sold at banks are marketed more aggressively to older Americans.**

  While only about a third (34 percent) of all bank customers have been contacted by their banks about investing in mutual funds, 47 percent of those aged 65 and above have been marketed to in such a fashion.

- **There are pockets of "below average" understanding of the financial risks involved in bank-sold investments.**

  Men are twice as likely as women to know that stocks, mutual funds and annuities are not FDIC insured. For example, 29 percent of men know that

mutual funds are not FDIC-insured compared to only 10 percent of women. On stocks, 39 percent of men know they are not FDIC insured, compared to 15 percent of women. Five percent of widowed or divorced women realize that stocks offered by banks are uninsured.

Even though low-income Americans (making $20,000 a year or less) are almost as likely as higher-income Americans to buy mutual funds, stocks and annuities from banks, they are considerably less likely to know that such products are not FDIC insured. Only 7 percent of low-income bank customers know that stocks and mutual funds are uninsured. Just 4 percent are aware of the uninsured status of annuities. Though awareness of the limits of FDIC coverage rises somewhat with income and education, considerable confusion is evident even among Americans with the most wealth and schooling. For example, only 33 percent of those making $60,000 a year or more think that mutual funds sold by banks are not FDIC insured. Just 21 percent of those with a college education think that annuities sold at banks are nct FDIC insured.

The NASAA/AARP findings are consistent with the results of a similar, but narrower public opinion survey released in November 1993 by the U.S. Securities and Exchange Commission (SEC) that focused on consumer beliefs about FDIC coverage of uninsured investments at banks.

What concerns state securities regulators is that more and more we will see the financially unsophisticated consumers -- those who are the least able to recognize sometimes subtle distinctions between bank products -- targeted by bank promotional campaigns. A study by financial researcher Phoenix-Hecht showed that about 20 percent of all newcomers to mutual funds make their purchases through banks. Larry Cohen, a vice president of Phoenix-Hecht observed that novice investors are drawn to banks partly because of familiarity with the institution.[10] A study released in 1988 by the Market Facts research firm concluded that "banks will succeed in the sale of nontraditional banking products only focusing on unsophisticated buyers, often first time investors."[11] The authors of the report advised banks to go after the bread-and-butter customers, the "ones who are confused and a little distrustful of financial products."[12]

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[10] Kalen Holliday, "Banks Keeping Up in Race to Lure New Investors," American Banker, December 22, 1993, p. 16.

[11] Lawrence A Darby, "To Market New Products, Target the Confused Buyer," American Banker, April 26, 1990, p. 4.

[12] Ibid.

What is significant in this context is that banks are continuing to find ways to benefit from what may be the most important thing they still have going for them -- trust. Surveys show that people continue to have more confidence in banks than other financial institutions.[13] That trust, of course, is rooted in one basic fact: money placed with a bank comes with the federal government's guarantee that it will always be there, even if the bank fails. Although the government insurance does not extend to investment-related products sold on bank premises, that fact is so often downplayed or completely omitted that it not surprising that consumers are confused.

While misleading or inadequate disclosure is a problem in this connection, so too are identical or similar names. The reasoning behind common or similar names appears to be simple: a bank's name can be a powerful draw in a local market. A good example of how it is that banks trade on the trust they have built up may be found in the case of the Minnesota bank that was planning to put financial planners in several branches. The bank decided to identify the planners as employees of the bank's brokerage affiliate (which had a name similar to that of the bank) because a pilot program revealed that bank customers were more comfortable when they believed that the planners were affiliated with the bank.[14]

CAPITALIZING ON CONFUSION: A LOOK AT BANK SALES PRACTICES

An informal state-level[15] look at the marketing, promotional and sales activities of banks offering uninsured investment products provides startling anecdotal evidence that may help explain why it is that there is widespread consumer confusion and misunderstanding about the risks and fees associated with these products now widely available through

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[13] Jerry Knight, "Banks Becoming Financial Supermarkets," Washington Post, August 23, 1993, p. A1. Barry Barbash, Director of the Securities and Exchange Commission's Division of Investment Management, commented on the results of the focus group sessions being conducted by the SEC and the Office of the Comptroller of the Currency to gauge how well consumers understand the differences between mutual funds and insured deposits: "One thing that comes clearly out of the focus groups is that bank depositors really do think of banks as bastions of safety." (Debra Cope, "Regulators Probe Public's Knowledge of Fund Risk," American Banker, January 27, 1994, p. 16.)

[14] Karen Talley, "First Bank System to Place Financial Planners in More Branches," American Banker, October 27, 1993, p. 17.

[15] Twenty state securities agencies contributed information used in developing this testimony. The states include: Arkansas, Colorado, Georgia, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Missouri, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, South Carolina, Texas, Vermont, Washington state and Wisconsin. The state securities divisions were contacted in mid-February and asked to provide us with information on hand or to go into the banks in their area to gather information on the marketing, promotional and sales activities taking place

banks. What state securities regulators uncovered in their visits to bank lobbies is a marketplace rife with misleading advertising and promotional materials, a systemic breakdown in the distinction between traditional insured activity and the sale of uninsured products, and a serious gap in the consumer protections available to those who purchase investment products on bank premises.

Below are illustrative examples of what state securities regulators found in each of the following major areas of concern: (1) suitability/risk disclosure; (2) misleading references to FDIC and Securities Investor Protection Corporation (SIPC)[16] coverage; and (3) a blurring of the distinctions between bank activities and brokerage activities, including the use of similar or identical names.

SUITABILITY CONCERNS/RISK DISCLOSURE

o An elderly Washington state resident complained to the Washington state Securities Division that she was misled by a **Tacoma, Washington** bank when she was persuaded to put funds from a maturing certificate of deposit (CD) into a mutual fund. The woman, a Yugoslavian immigrant, had intended to withdraw the funds from the maturing CD and take the money to another bank paying a higher return. When bank personnel learned this, they suggested that the depositor could earn a higher return by putting her money in a "government fund." When the woman asked whether the account would be FDIC insured, she was told that it was a secure investment because it was a government fund. She was told that the return would be significantly higher and that there would be no risk. The bank customer was not advised that this was an uninsured investment account rather than a traditional bank deposit account. The receipt she was given had the bank's name on it, as did the customer account form. There is no mention on any form that the money was being put into an uninsured investment product. It was only when a broker contacted her nearly two years later to advise her to withdraw her funds from the account because she was losing money that the woman learned that her money -- which represented her life savings -- had been put in a uninsured investment product and that the principal of her investment had been reduced by nearly $12,000. When the woman went to the bank to complain, she learned that the assistant branch manager for the bank was the very person who sold her the investment product and claimed that it was safe! (The assistant manager admitted that she was not licensed to sell securities at the time she sold the mutual fund to the woman in question her, although she claims she could "offer" securities at that

[16] The Securities Investor Protection Corporation (SIPC) is a nonprofit membership corporation, funded by its member securities broker-dealers. SIPC does not protect investors against losses from the rise or fall in the market value of specific investments. What it does is provide protection against certain losses if a SIPC member fails financially and is unable to meet obligations to its securities customers. (See, How SIPC Protects You, a 1992 publication of the Securities Investor Protection Corporation, Washington, D.C.)

time. She apparently now is licensed as a securities broker and continues to serve as the assistant branch manager for the bank.)

- The Colorado Division of Securities received a complaint from the daughter of an 80-year old widow who had been contacted by her **Denver, Colorado** bank (with which she had done business for 20 years) about investment products at the time her CD was maturing. The widow, an East German emigree, was told she could earn better interest rates if she moved her funds from the CDs into a mutual fund account. The woman later learned that it was not bank personnel she was dealing with when she was persuaded to put her funds in mutual funds, but rather a brokerage firm that has a relationship with the bank. This 80-year old woman's life savings was put into a load mutual fund that had about $4,000 in fees. Despite her complaints about suitability, the woman has been instructed that because she signed all the proper forms, there was no avenue of redress.

- A retired **Crystal, Minnesota** man on a fixed income was invited to his local bank to discuss options when his certificate of deposit (CD) was about to mature. When the man went to the bank for the meeting, he was unknowingly directed to speak to an investment sales representative and not a bank employee. During the meeting, it was suggested that the funds be placed in an investment vehicle that would pay a higher rate of interest than the CD, and equal to a CD in terms of safety and liquidity. When the man explained that he was not at all interested in any stock deal, he was reassured that what he was getting into would be very similar to the CD. Ultimately the man agreed to put his funds in what turned out to be a limited partnership, which contrary to the assurances, paid lower interest and was not at all liquid. The retiree explained that he had signed the necessary disclosure forms but that he was not given an opportunity to read them, nor was he provided and explanation of what he was signing. The limited partnership prospectus did not arrive at this home until several days after he had made the investment. Although the gentlemen later learned that he was dealing with a representative of the brokerage firm affiliated with the bank, at the time he believed he was dealing with representatives of a bank he had grown to trust. The investor claims that there was no physical separation between the banking and brokerage activities and that there were no posters or other signs that would alert someone that they were no longer dealing with a bank representative.

MISLEADING REFERENCES TO FDIC/SIPC COVERAGE

- The promotional materials for the brokerage services of a **Wichita, Kansas** bank suggest that *"All securities in your Brokerage Account are protected by the Securities Investors Protection Corporation for up to $500,000 (limited to $100,000 for claims for cash)."* Customers may mistakenly -- but understandably -- read that statement coming from a bank to mean that the "protection" works in

much the same manner as FDIC insurance. Brochures in the bank lobby describing the investment-related services of the brokerage unit failed to include any mention whatsoever that these products are not FDIC-insured.

o When asked about government insurance on a mutual fund, a sales representative operating in the lobby of a **Boston, Massachusetts** bank said that a mutual fund was as safe as a certificate of deposit (CD). The representative added that the mutual fund is safer in some respects because a "an investment in a fund is protected by SIPC up to $500,000, while a CD is only protected up to $100,000." When asked if SIPC was a federal agency like the FDIC, the representative said "no," but that it provided similar protection.

o Brochures promoting the services of a **Lincoln, Nebraska** bank include "Investment Alternatives" under the general heading of "Savings Plans." Although there is a one-line, fine-print sentence indicating that investment products are not FDIC insured, an open panel on the back of the brochure reads "FDIC INSURED" in a general way. If the customer sees the cover, the first panels of text and the back of the brochure, the message certainly would be that the products carry FDIC insurance.

o Slick promotional materials for the brokerage affiliate of a **Kansas City, Missouri** bank omit entirely any discussion of the lack of FDIC insurance for these products. The brochures appeared in a bank lobby.

o The brochure for the brokerage affiliate of a **Little Rock, Arkansas** bank advertises its investment-related services and prominently discloses the brokerage's ties to the bank. In fact, the bank name and logo appear in large print, as does the "Member FDIC" notice. Nowhere on the brochure is it stated that FDIC coverage does not extend to investment products.

o The back panel of a brochure promoting the brokerage firm affiliated with a **Denver, Colorado** bank describes the uninsured nature of investment products in this manner: *"____ Securities Corporation is not a bank and* ***some*** *of the investments it makes available are not obligations of, or guaranteed by a bank, nor are they insured by the FDIC."* (Emphasis added.) Another brochure put out by the same brokerage firm includes the following "disclosures," which takes the FDIC/SIPC confusion to the worst extremes uncovered so far:

> ***You have access to a variety of safekeeping services.*** *Securities held in your investment account are covered up to $10,000,000 of protection, as detailed in the box below.* (See next page.)

Protection Insurance
SIPC
(Securities Investor Protection Corporation) --
(Including $100,000 in cash)
up to $500,000

Equitable Casualty and
Surety Company
$9,500,000

Total Coverage **$10,000,000**

BLURRING THE DISTINCTION BETWEEN BANKING AND BROKERAGE ACTIVITIES

- An **Arlington, Virginia** bank uses the same logo and a nearly identical name for both its traditional banking functions and its uninsured investment operations. Additionally, the bank logo is imprinted on all of the inserts in a brochure detailing the banking, insurance and investment services of the institution. Brochures for both insured and uninsured products are commingled in the bank lobby and large posters just a few feet from the teller's windows advertise the availability of the investment products. The lobby posters do not disclose the uninsured nature of these investment vehicles.

- A **Maine** investor did business with a brokerage firm operating out of a bank lobby and using a name identical to that of the bank. He was unable to understand the difference between dealing with a bank and a securities firm. In his complaint to state regulators, the investor made repeated reference to what "his bank had done to him." His dispute actually was with the brokerage firm and involved the fees associated with a municipal income fund he purchased after cashing in his certificates of deposit.

- Customers of a **Topeka**, **Kansas** bank may understandably be confused by the promotional materials for the affiliated brokerage firm that goes by an identical name, has the same logo and uses exactly the same artwork as the bank.

- Examiners from the Colorado Securities Division illustrated the blurring of the lines between banks and brokerages and the concerns about inadequate disclosure in a report describing the various signs in a **Denver, Colorado** bank lobby. For

example, in the area of the bank where investment sales representatives were located there was a small sign signifying "NASD member" and "SIPC." There were no signs indicating that the products being made available by the brokerage firm were not FDIC insured. In addition, a "State of Colorado Charter Bank" sign was displayed on the table immediately adjacent to the investment sales representative's desk.

o A **Boston, Massachusetts** bank and its brokerage affiliate share an identical name and logo which is printed on the front cover of prospectuses for uninsured investment products. Brochures available in the bank lobby contain inadequate disclosure with respect to the risks associated with investment products and no information discussing fees is made available. Finally, there is no physical separation between the investment sales representatives and the bank's customer service personnel. There are no signs that would distinguish the investment and banking-related services.

o A newspaper advertisement for the investment center affiliated with a **Topeka, Kansas** bank reads *"Alternative Investments Are Now Available Where You Bank."* Readers are advised that they may call a bank representative who will set up an appointment with the investment executives. The ad directly equates traditional investments (e.g., savings, CDs, etc.) with uninsured products, making them appear to be merely different alternatives.

o The securities arm of a **Denver, Colorado** bank makes available to customers a brochure that asks:

Why Talk to ____ about my investment needs?

A Reliable Financial Planner

For three generations ____ has enjoyed the reputation of being a premier financial institution. We have been satisfying financial needs with products such as checking and savings accounts, loans and CDs. But, did you know we also provide personal professional investment service through (name of brokerage firm)?

The return card asks consumers to indicate whether they are customers of the bank and, if so, what branch they most frequently visit.

o A newspaper advertisement running in papers in **Little Rock, Arkansas** display the names of several big brokerage firms and then asks the reader: *"Which Brokerage Firm Also Offers the Unique Insight of Arkansas' Largest Bank?"* In the text of the ad it is asserted that the brokerage firm in question has not only the expertise

and capacity of any national brokerage firm, it also is the "only firm" to offer the "service, convenience and unique insight of the region's premier banking organization." Readers are encouraged to find out "how a regional bank can meet your investment needs on a national scale."

ACTUAL BANK SALES PRACTICES: WHAT SURVEYS SHOW

While many states have visited bank lobbies over the last several weeks to gain a better understanding of how it is that banks are promoting their brokerage activities, the Texas State Securities Commission and the New Jersey Bureau of Securities each conducted very similar informal surveys during February 1994.[17] It is instructive to look at the results of the surveys conducted in these two states and to compare those findings with what was uncovered in a Consumer Reports[18] investigation of 40 banks in five states. (See the next page for side-by-side comparison of survey results.)

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[17] Examiners from the Texas State Securities Board targeted three general geographic regions and, posing as potential customers, requested information on uninsured bank products. The geographic regions were Houston/La Grange, Austin/Georgetown/San Antonio, and Dallas/Irving. In total, 30 banks were visited. The New Jersey Securities Bureau visited a total of 18 banks in Bergen, Middlesex, and Morris counties.

[18] "Should You Buy Mutual Funds From Your Bank?" Consumer Reports, March 1994, pp 148-150.

ISSUE	TEXAS	NJ	CR
Banks offering investment products	80%	72%	100%
Banks with a visual display disclosing investment products are not insured	25%	0%	---
Banks in which the insured and uninsured activities are physically separated	41%	57%	"few"
Banks in which risk and suitability issues were discussed in presentation	50%	14%	15%
Banks in which potential loss of principal was discussed	29%	42%	18%
Banks in which fees were discussed	---	33%	20%
Banks in which dual employees or bank personnel made investment presentation	20%	---	---

The nearly identical results of these three independent surveys go a long way in explaining why it is that consumers are confused about the uninsured nature of investment products and the risks and fees associated with them.

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CLOSING THE CONSUMER PROTECTION GAP: CURRENT AND NEEDED REMEDIES

Mr. Chairman and Members of the Subcommittee, there can be no doubt that the existing statutory framework is woefully outdated and not up to the demands of a rapidly changing marketplace. Others who have testified before me have provided an excellent overview of the shortcomings of our current laws. I will not repeat those points, but rather will discuss pending measures and other steps NASAA believes should be taken to address the serious consumer protection problems arising from the ever-widening sale at banks of uninsured investment products.

As you may know, NASAA, AARP and the Consumer Federation of America (CFA) developed the following minimum standards for evaluating Congressional reform legislation in this area:

- ***Mandatory use of disclosure that is proven to work***. It is clear that what is being done now in terms of disclosure is not working. Disclosure about the risks of uninsured bank products should be in the form of a concise and "simple English" document and related lobby posters. No sale of an uninsured product should be permitted to take place before the disclosure document is provided and the consumer signs a statement indicating an understanding that mutual funds, stocks and annuities sold at banks are not FDIC insured. In view of the apparent ineffectiveness of current disclosures, AARP, CFA and NASAA are prepared to assist in the development and testing of model disclosure documents and other materials that can be proven to be effective at eliminating the current consumer confusion about the extent of FDIC insurance coverage.

- ***A ban on naming or advertising uninsured bank products in any way that creates confusion with insured bank products or the institution itself.*** Many consumers mistakenly believe that uninsured bank products are FDIC insured in the same manner as traditional bank products. As a result, every precaution must be taken to avoid undue confusion in the consumer's mind about the "dividing line" between uninsured products on the one hand and the safety and soundness of the bank and its traditional insured products on the other. The use of the same or similar names and logos of banks and their affiliates or subsidiaries should be prohibited. Additionally, some mutual funds and other uninsured investment products sold at banks should be renamed in order to bring an end to existing instances of the blurring of the line between uninsured and insured bank products.

- **No "gap" in the consumer protection available to bank customers buying investment products.** Consumers who invest in mutual funds and stocks through brokerage firms or investment companies are provided a comprehensive framework of consumer protections, including suitability requirements, fair dealing and disclosure of risks and costs. Though much of the activity in investments sold through banks is conducted by subsidiaries registered as broker dealers, there is the potential for banks to deal directly with individuals and firms who would not be subject to broker-dealer regulation. This disturbing possibility has already become reality in some instances. At the same time, a serious effort must be undertaken to review the extent and effectiveness of current state and federal regulatory oversight. All investors in mutual funds, stocks and annuities should be accorded the same level of consumer protection.

- **A mandatory physical separation of the sale of insured and uninsured products within banks.** The commingling of insured and uninsured activities in bank lobbies greatly increases the potential for consumer confusion. Because of this, no bank should be able to sell insured and uninsured products from the same desk, window or lobby area. A clear, physical separation should exist (along with appropriate lobby posters) in order to distinguish the areas within banks where the two types of products are sold.

NASAA is pleased to lend its strong support for H.R. 3447, the "Securities Regulatory Equality Act," legislation which would provide for the functional regulation of bank securities activities and thus close the "consumer protection gap" that now exists. The current mismatched regulatory system has forced most securities regulators, for definitional and jurisdictional reasons, to watch from the sidelines as banks become more and more active in the securities marketplace and the banking regulators grapple with a previously unknown world. The continued exclusion of banks from the definitions of "broker" and "dealer" serves no public interest, and to the contrary, means that banks need not comply with the customer protection, net capital, and books and records rules specifically designed to protect investors. What purpose is served in allowing for expansive securities powers for depository institutions and yet not subjecting those activities to legally-enforceable and appropriate oversight? It certainly is not investor interests that are served by such a gaping hole in the regulatory structure. Banks that act as broker-dealers, are, of course, subject to federal banking laws. However, those laws are designed to protect the banks and their depositors, not investors.

In addition, banks may serve as investment advisers to certain mutual funds without registering under the Investment Advisers Act of 1940. As a result of this loophole, shareholders in mutual funds advised by banks, unlike their counterparts in other mutual

funds, do not receive the protections of that Act's provisions, including those related to the recordkeeping and inspections conducted by the Securities and Exchange Commission (SEC) and those restricting performance-based fees and agency cross-transactions. H.R. 3447 would remove the exclusion for banks from the definition of "investment adviser" under Section 202(a)(3) of the Investment Advisers Act if the bank or bank holding company acts as an investment adviser to a registered investment company. NASAA strongly supports this provision.

H.R. 3447 not only addresses the consumer protection gap by significantly narrowing the exclusions from the various securities laws for banks, the legislation also addresses the issue of similar or common names. Section 116 of the bill would prohibit any registered investment company that has as an investment adviser or distributor a bank or its affiliate from adopting any word or design that is the same as, similar to, or a variation of the name, title or logo of the bank. NASAA's view is that such a requirement will greatly assist in reducing consumer confusion concerning the uninsured status of investment-related products. NASAA further believes that such requirement should be applied retroactively.

As Congress considers this issue, NASAA respectfully encourages you also to incorporate measures requiring plain-English disclosure so that consumers are provided with meaningful and understandable information on which to base their financial decisions and that you consider the issue of physical separation of the banking and brokerage activities in bank lobbies. Both issues have emerged as particularly troubling to consumers and should be corrected.

STATE EFFORTS

It also is recognized that a serious effort must be undertaken to review the extent and effectiveness of current state securities regulatory oversight. The first order of business for state securities regulators was to gather information about what is going on in the marketplace and to get a better sense of how it is that banks are entering the securities business. The NASAA committee which I have been asked to chair, the Banks Securities Committee, was established last September and we have been charged with reviewing state securities laws and regulations to determine what changes we may need to make to take into account the expanding role banks are playing the securities marketplace. In addition, NASAA is taking a hard look at our current authority to see what changes may be necessary in our oversight of registered broker/dealers who operate on bank premises. In addition, a number of individual states also are moving to put in place new rules governing the bank activities of broker/dealers.

CONCLUSION

Mr. Chairman and Members of the Subcommittee, it is abundantly clear that more and more consumers are turning to their banks for the purchase of uninsured investment products. What also is evident is that many of these consumers are very much in the dark about the uninsured nature of the investment products and the risks and fees associated with them. Given what state securities regulators have turned up in their informal look at the promotional, marketing and sales practices in bank lobbies, it is not at all surprising to me that consumers are confused. How could they not be in the face of such a soothing and misleading barrage of advertisements and bank lobby sales pitches?

It is NASAA's view that the time has come for federal legislation to comprehensively address the interrelated issues of securities activities conducted on bank premises and appropriate safeguards to protect investors. We know that banks already are in the securities business in a major way. The proposed Mellon/Dreyfus merger serves to underscore and to bring into focus the concerns expressed by NASAA and its members about the steadily increasing role of banks in the securities markets and the lack of legally-mandated investor safeguards. NASAA urges Congress to move quickly to adopt H.R. 3447. At the same time, we would urge federal banking regulators to proceed cautiously and to exercise restraint with respect to allowing new investment-related activities on bank premises before the appropriate investor safeguards are put in place.

NASAA

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TIPS FOR CONSUMERS ON MUTUAL FUNDS SOLD AT BANKS

There are NO guarantees, NO bail-outs and NO insurance "safety nets" to protect you against losses in the mutual funds and stocks now being sold at an increasing number of U.S. financial institutions. Many Americans mistakenly assume that **all** products sold within the four walls of a bank are protected by the Federal Deposit Insurance Corporation (FDIC).

<u>What are the facts?</u> **Consumers who buy mutual funds, stocks and annuities at banks do <u>not</u> benefit from the Federal Deposit Insurance Corporation (FDIC) coverage available for deposits of up to $100,000 per customer.** This means that investors are <u>not</u> eligible for the same federal insurance that protects depositors who put their money in traditional bank products, such as savings accounts and certificates of deposit (CDs). And just as there is no insurance coverage from the federal government for mutual fund investors who lose money, your bank is <u>not</u> obligated in any way to return all of what you first invested in an uninsured product. In other words, you face **exactly** the same risk in buying uninsured products at a bank that you do when making such investments through a brokerage firm, investment company or insurance company. **There is no guarantee that you will get back what you invest in uninsured products sold at banks.**

Does this mean that you should avoid buying uninsured investments at your bank? **Not at all.** Banks are now another option for consumers who have money to invest in mutual funds, stocks and annuities and understand the risks in doing so.

<u>What do you need to know first?</u> The "tip sheet" you are now reading has been prepared for bank customers contemplating the purchase of **mutual funds**. (Most of the "self defense" advice set out here will also prove useful if you consider the purchase at a bank of the other major uninsured products: **stocks and annuities**.) This document has been designed to help clear up the major areas of consumer confusion about uninsured bank products identified

in a major national public opinion survey conducted by the American Association of Retired Persons (AARP) and the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 state securities regulators.

HOW MUTUAL FUNDS WORK

Mutual funds offered at banks are no different from those sold directly by investment companies or by salespeople at brokerage firms. Like any other uninsured investment, mutual funds involve risk, which is what makes it possible for an investor to make money. The same risk also means that you can lose money you've invested in a mutual fund. (For a discussion of risk in money market mutual funds, see below.) Unlike a certificate of deposit, which offers a fixed return for a specific period of time, mutual funds may go up or down in value during every day of trading.

A mutual fund is a company that pools the financial resources of thousands of investors. Instead of just buying a single security, the mutual fund buyer gets a "basket" holding dozens of stocks or bonds. (Mutual funds sold at banks include both stock and income funds.) Mutual fund managers decide when to buy, sell and hold investments in the securities that go into the baskets. The idea here for small investors is that mutual funds help to minimize risk through diversification and also make available the expertise of the fund manager. Each day, the fund must determine the value of the stocks in its portfolio. The overall value of the "basket" of securities divided by the number of outstanding shares in the mutual fund yields the Net Asset Value or NAV. The NAV is what tells you how much each share of a mutual fund is worth.

Money market funds are a type of mutual fund. Among all uninsured products sold by banks, money market mutual funds are the investments consumers are most likely to believe are FDIC insured. They are not. However, there have been no major losses in money market funds in the U.S. to date. (Money market mutual funds should not be confused with interest-bearing "money market accounts," which are insured by the FDIC. Make sure that you are clear on which type of "money market" you are considering.) Another special category: so-called "insured" mutual funds in the tax-exempt municipal fund market. Do not be confused by the reference to insurance, which is not extended by the FDIC. The limited, private insurance in such funds extends only to credit risk for the mutual fund issuer and is not intended to return money to investors in the event of a decline in the value of mutual fund shares.

AVOIDING CONFUSION ABOUT MUTUAL FUNDS AT BANKS

Mutual funds are sold at banks in two major ways. Some banks rent out space in their lobbies so that outside brokerage firms and investment companies can set up shop. Others make arrangements to offer "private label" mutual funds, which may be very closely linked to the identity of the bank. (Be careful! Some mutual funds offered through banks bear

names that are confusingly similar to those of the financial institutions.) The AARP/NASAA survey identified the following messages as being critical to clearing up the **extensive misconceptions and uncertainty** that now exist on the part of bank customers when it comes to mutual funds sold at financial institutions:

1 **Keep in mind that mutual funds (including money market funds) sold at banks are not insured by the federal government.** No mutual funds are insured by the FDIC. Only insured bank products (such as savings accounts and certificates of deposit) are eligible for FDIC protection. You can lose money invested in a mutual fund, whether it is sold at a bank, brokerage firm or directly from an investment company.

2 **Beware of advertising and mutual fund names that blur the line between a bank's insured and uninsured products.** Your bank is not obligated to cover losses suffered in a mutual fund investment that you buy at it. Some bank advertising and mutual fund names may leave you with the impression that there is no difference in the protection offered for uninsured and insured products. Make sure that you understand whether the product you are purchasing is insured or uninsured.

3 **Recognize that mutual funds (including those sold at banks) are very different from fixed-rate investments, such as CDs.** The purchaser of a CD is promised a specific rate of return by a certain date. Additionally, this product is covered by the FDIC. By contrast, mutual fund prices can go up and down every day, past performance is no guarantee of future results and the investment is completely uninsured. A mutual fund can return far more to you than a savings account or CD, but this potential for gain is only made possible by risk, which is what also exposes you to the potential loss of your principal. (Keep in mind that money market mutual funds have historically involved less risk than other mutual funds.)

4 **Determine your investment objectives and risk tolerance and then find a mutual fund that is a good match.** Professionals selling mutual funds through banks are supposed to determine if an investment is appropriate for you, but many investors indicate that they are not being asked questions about the "suitability" of a particular mutual fund for their circumstances. What are your plans and what investments do you need to achieve them? Do you need stability, growth or a steady income stream from your investments? How much risk can you afford to assume in pursuit of higher returns? These are the questions that will help guide you to the type of mutual fund that is best for you. Most investors will find that it makes sense to diversify their portfolio, rather than placing all of their nest eggs in one "basket."

5 **Always "comparison shop" for mutual funds ... especially if you are a first-time investor.** Many bank customers buying mutual funds are novices. Such individuals are likely to rely on a sales pitch, rather than doing their own homework. Sound difficult? It isn't if you follow some simple steps! First, avoid the trap of relying on verbal assurances from sales people and get everything in writing. Second, shop around and see what mutual funds are being offered at other banks and brokerage firms. Just because you

have your checking and savings account at a bank does <u>not</u> mean that you are obligated to buy uninsured investment products there.

6 **Make sure that you know about all fees and charges associated with your mutual fund.** Most bank customers who buy mutual funds have a poor understanding of the fees and charges involved in their investment. Always make sure that you know what an investment is going to cost before you enter into it. All fees associated with a mutual fund are summarized in the fee table in the prospectus. A **front-end "load"** (or asset-based sales charge) may not exceed 8.5 percent of the total purchase price and usually serves as a commission to compensate the broker or other sales agent who assists you. Many banks sell mutual funds featuring these front-end "loads." You may be able to lower or eliminate this sales charge by buying the same or comparable fund directly from an investment company. A **back-end charge** (or contingent deferred sales charge) declines over time and is collected at **redemption**, when you take money out of your mutual fund account. **Management fees** (sometimes referred to as "investment advisory fees" or "account maintenance fees") are imposed by fund advisors in order to cover the cost of overseeing the mutual fund. So-called **"12 b-1" fees** are used to pay for the marketing and distribution of the mutual funds. Some mutual funds have no front-end load, but make up for it by imposing back-end charges and a 12 b-1 fee. Make sure that you understand <u>all</u> fees and charges before investing.

7 **Look "under the hood" of any mutual fund you consider buying.** Too many first-time investors rely almost exclusively on sales pitches and slick promotional materials in buying a mutual fund. A prospectus disclosure document is available for all mutual funds. The prospectus can be the key to your understanding of the mutual fund and whether it is a good match for you. Examine the investment objective section and compare it to what makes the most sense for you. Review the types of risk associated with the mutual fund. Look at the fees and compare them to similar funds with comparable objectives.

<u>IMPORTANT:</u> This discussion is <u>not</u> intended to be a comprehensive introduction to mutual fund investing. A number of excellent consumer guides on mutual funds are available at little or no cost from the Investment Company Institute (ICI). For more information, call ICI at 202/326-5872. This document has been prepared by NASAA to help clear up misconceptions in the minds of consumers about mutual funds and other uninsured products sold at banks. **Its purpose is <u>not</u> to discourage any suitable individual who wants to invest in mutual funds at a bank, brokerage firm or investment company from doing so.** Mutual funds are an important part of the financial picture of most investors.

WHERE TO COMPLAIN ...

If you have a problem with your mutual fund or do not understand something that has been mailed to you about the investment, contact the brokerage firm unit in your bank. If this step does not satisfy you, ask the bank to look into the matter. **An unresolved problem involving your investment or potential misconduct on the part of a broker or other sales agent will require additional steps.** For help in dealing with these matters, contact your state securities agency, which oversees the conduct of brokers. For the telephone number of your state securities agency, call the North American Securities Administrators Association (NASAA) at 202/737-0900.

Mr. DINGELL. Thank you very much. We are going to work on that legislation. And without objection, there are a number of items included in your statement which will be inserted in the appropriate place.

Ms. Archuleta, we are delighted to have you with us this morning and you will be recognized for such a statement as you would like to give.

TESTIMONY OF LENA ARCHULETA

Ms. ARCHULETA. Mr. Chairman, and a special greeting to our own Dan Schaefer, the representative from Colorado. I am Lena Archuleta and I am a member of the board of directors of the American Association of Retired Persons and I am pleased to be here today to present AARP's view on bank sales of uninsured products.

Gone are the days when every product encountered in the bank lobby was federally insured. All sorts of uninsured products are now being sold at banks, including annuities, mutual funds, life insurance and brokerage services. While the range of products offered by banks has been increasing, something else has increased: consumer confusion.

Indeed, today's financial service marketplace is more complex and confusing than ever before. Consumers today are being subjected to aggressive marketing campaigns touting the virtues of uninsured products and their ready availability at local branch banks. These advertising and promotional campaigns sometimes blur the distinctions between what's insured and what's not and, as a result, current banking practices are contributing to marketplace confusion.

Banks selling uninsured products tend to fall into one of three categories. Banks that are rushing to the bottom. A large number of banks are engaged in questionable practices. These include using identical logos for insured and uninsured products, using names similar to the bank's to identify bank-offered mutual funds, not disclosing the deposit insurance status on some uninsured products, and commingling lobby advertising and promotional literature for insured and uninsured products.

And, banks that are providing perfunctory legalese disclosures. Many of the banks in the country are providing perfunctory legalese disclosures, but these are usually provided in very small, light print that often requires a magnifying glass to decipher, or buried as footnotes that require some hunting to find, or appear in lobby advertisements that require a customer to stoop down in order to read.

And then there are banks that are rising to the occasion by going beyond minimal requirements. A handful of banks provide highly visible disclosures in lobby displays, brochures, forms and advertising that are designed to make the distinctions between insured and uninsured products abundantly clear to the consumer.

A recent AARP NASAA survey indicated that four out of five consumers are unaware that investments sold through banks are not insured. These troubling statistics lead us to the conclusion that it is time for the Federal Government to step in to bring some sense to today's marketplace.

Guidelines by Federal banking regulators represent nothing more than the quick fix to what does not solve underlying problems. Enactment of mandatory Federal standards is needed to accomplish consumer protection goals. The following actions are needed:

Congress must pass strong consumer protection legislation. Strong congressionally mandated protections are needed for consumers who might unwittingly place their life savings in jeopardy by investing in uninsured products at their bank. Passage of Federal legislation is needed before a market correction causes unexpected losses for investors who are lulled into a sense of security in purchasing uninsured products at their bank.

Second, banking regulators must proceed with extreme caution. Until the above statutory protections are in place, AARP urges the Federal banking regulators to proceed with extreme caution before approving any new banking activities which could exacerbate consumer confusion.

And banking regulators must improve enforcement. The Federal banking regulators are to be commended for identifying and taking some initial steps to address consumer protection issues relating to bank sales of uninsured products. Much more, however, needs to be done to protect consumers adequately. The banking regulators need to implement the following enforcement strategies for identifying and correcting marketplace abuses.

Number one, they should send testers into bank lobbies to more accurately gauge conditions in the marketplace. Anonymous testers need to be sent to the bank lobbies to gather information on bank sales practices, product promotions, all representation, written disclosures and other related activities.

Another strategy, develop a system for capturing consumer complaints. Most customers do not know where to complain if they have problems with uninsured products sold in banks. To assure that all complaints are being captured, a uniform consumer complaint form needs to be developed, made publicly available in bank lobbies and distributed to all purchasers of uninsured bank products.

Hold public field hearings. The Federal banking regulators need to hold a series of field hearings around the country to solicit public opinion related to bank sales of uninsured products. Such forums would generate significant media attention in the cities where they are being held and would help educate the public on the difference between insured and uninsured products.

AARP appreciates this opportunity to comment and we look forward to working with the subcommittee toward achieving the goals identified above.

And I know we will be hearing from Diane Colasanto later who will report on the survey done by the two groups.

[The prepared statement of Ms. Archuleta follows:]

Statement Of

Lena Archuleta
Member, Board Of Directors
Of The
American Association Of Retired Persons

Hello, my name is Lena Archuleta. I'm a member of the Board of Directors of the American Association of Retired Persons from Denver, Colorado. I'm pleased to be here today to present AARP's views on bank sales of uninsured products.

Gone are the days when every product encountered in a bank lobby was federally insured. All sorts of uninsured products are now being sold at banks, including annuities, mutual funds, life insurance, and brokerage services. While the range of products offered by banks has been increasing, so has something else: consumer confusion! Indeed, today's financial services marketplace is more complex and confusing than ever before.

Older people are among the most vulnerable groups in this environment. Many older investors have seen the income from their insured savings accounts and certificates of deposit drastically lowered by plummeting interest rates. This substantial loss of income has driven many older people into much riskier investments. Some older people have made these investments without fully understanding the risks involved.

AARP, along with the North American Securities Administrators Association (NASAA), recently released the results of a national survey which graphically demonstrated the degree to which consumer confusion reigns. A whopping 82% of survey respondents were unaware of the deposit insurance status of mutual funds sold by banks. 86% were unaware of the deposit insurance status of bank-sold annuities. Diane Colasanto, from Princeton Survey Research Associates who conducted the AARP/NASAA survey, is here to discuss the survey findings a little later.

Mutual funds, annuities, and other products may represent attractive investment opportunities which promise greater returns than insured deposit accounts. AARP certainly does not want to discourage older investors from considering these products. But, investors

must be fully informed about the products they are purchasing and the risks they are assuming. They must enter into these transactions with their eyes wide open.

Part of the responsibility for deciphering today's marketplace obviously rests with the consumer. Consumers need to learn more about the various products they encounter. They need to be able to sort through the bewildering array of products and select those best suited to their needs. Before this can occur, however, steps must be taken to assist consumers in finding their way through today's financial services marketplace.

Consumers today are being subjected to aggressive marketing campaigns touting the virtues of uninsured products and their ready availability at local bank branches. These advertising and promotional campaigns sometimes blur the distinctions between what's insured and what's not. As a result, current banking practices are contributing to marketplace confusion.

Banks selling uninsured products tend to fall into one of three categories:

- **Banks that are rushing to the bottom**

  A large number of banks are not complying with existing federal banking guidelines. Questionable practices include: using identical logos for insured and uninsured products, using names similar to the bank's to identify bank-offered mutual funds, not disclosing the deposit insurance status on some uninsured products, and commingling lobby advertising and promotional literature for insured and uninsured products.

- **Banks that are providing perfunctory, legalese disclosures**

  Many of the banks in the country are providing perfunctory, legalese disclosures. These are usually provided in very small, light print that often requires a magnifying glass to decipher, are buried as footnotes that require some hunting to find, or appear in lobby advertisements that require a customer to stoop down in order to read.

- **Banks that are rising to the occasion by going beyond minimal requirements**

  A handful of banks provide highly visible disclosures in lobby displays, brochures, forms, and advertising that are designed to make the distinctions between insured and uninsured products abundantly clear to consumers.

When more than four out of five customers are unaware that investments sold through banks are *not* insured, it is time for the federal government to step in to bring some sense to today's marketplace. Guidelines by federal banking regulators and voluntary endeavors by banking industry trade associations represent nothing more than quick fixes which do not resolve underlying problems. Marketplace abuses need to be prohibited; better disclosures are required; stronger enforcement actions must occur. Enactment of mandatory federal standards is needed to accomplish these consumer protection goals. The following actions are needed:

- **Congress must pass strong consumer protection legislation**

  Congress has provided Americans with consumer protections

correcting marketplace abuses relating to home equity loans, credit cards, investment advisors, penny stocks, check holds, account disclosures, and a variety of other problems. Strong, congressionally mandated protections are needed for consumers who might unwittingly place their life savings in jeopardy by investing in uninsured products at their banks. AARP, NASAA, and the Consumer Federation of America (CFA) are developing a legislative proposal which incorporates many of the concerns identified by banking regulators and trade groups into a comprehensive consumer protection measure. Passage of such legislation is needed before a market correction causes unexpected losses for investors who were lulled into a sense of security in purchasing uninsured products at their bank.

- **Banking regulators must proceed with extreme caution**

  Until the above statutory protections are in place, AARP urges the federal banking regulators to proceed with extreme caution before approving any new banking activities which could exacerbate consumer confusion. If such approvals are to occur, up-front consumer protection commitments are needed.

- **Banking regulators must improve enforcement**

  The federal banking regulators are to be commended for identifying and taking some initial steps to address consumer

protection issues relating to bank sales of uninsured products. The Comptroller of the Currency has developed a very good brochure which clarifies the differences between investments and deposits. Much more, however, needs to be done to adequately protect consumers. The banking regulators need to implement the following enforcement strategies for identifying and correcting marketplace abuses:

Send Testers Into Bank Lobbies

To more accurately gauge conditions in the marketplace, anonymous testers need to be sent into bank lobbies to gather information on bank sales practices, product promotions, oral representations, written disclosures, and other related activities.

Develop A System For Capturing Consumer Complaints

Most consumers do not know where to complain if they have problems with uninsured products sold by banks. If they want to notify the bank's regulator, most people don't know whether to complain to the state banking commissioner, Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, or the Office of Thrift Supervision. If a complaint relates to the sale of a securities product, it might need to be sent to the Securities and Exchange Commission or the state securities regulator. If it relates to the sale of an insurance

product, the state insurance commissioner probably needs to be informed. To assure that all complaints are being captured, a uniform consumer complaint form needs to be developed, made publicly available in bank lobbies, and distributed to all purchasers of uninsured bank products. A system needs to be set up under which complaints lodged with one regulator are shared with other appropriate regulators.

Hold Public Field Hearings

The federal banking regulators conducted a series of field hearings when recently contemplating actions relating to the Community Reinvestment Act. Similar field hearings need to be held around the country to solicit public opinion relating to bank sales of uninsured products. Such forums would generate significant media attention in the cities where they are held and would help educate the public on the differences between insured and uninsured products.

AARP appreciates this opportunity to comment. We look forward to working with the subcommittee towards achieving the goals identified above.

Mr. DINGELL. Ms. Colasanto.

TESTIMONY OF DIANE COLASANTO

Ms. COLASANTO. Thank you.

My name is Diane Colasanto. I am president of Princeton Survey Research, a public opinion polling firm, based in Princeton, New Jersey. I am here to report on the results of a survey we conducted for AARP and NASAA.

In October, my company interviewed a random sample of 1,000 bank customers who say they are the financial decisionmakers for their households. What they told us makes clear that many still cling to notions about the safety of bank accounts when they think about the wide array of new products offered by banks.

They don't realize that the mutual funds, stocks and annuities sold by their banks are not insured by the FDIC program. Only 18 percent say the mutual funds sold by their banks are not insured. Twice as many, 39 percent, are wrong in thinking that bank mutual funds are insured. And another 43 percent say they just don't know.

What's really remarkable is that even the people who have actually purchased mutual funds at their banks are not well informed about the risks involved in these investments. We would expect at least this group of purchasers to be knowledgeable about whether their investments are insured or not. After all, they've spoken to someone at their bank about the investment, they remember receiving disclosure documents from their bank, and most say they read the disclosure information. But these investors are not knowledgeable about risk. In fact, investors are even more likely than other bank customers to think these bank products are FDIC insured.

Half the mutual fund investors think their mutual fund is insured, while only 17 percent know it's not insured. The remaining third of investors don't know whether or not their mutual fund is insured. These investors are confused about other aspects of their investment, not just risk. Between a quarter and a third don't know whether or not they're subject to a variety of common fees. For example, only 36 percent of bank mutual fund investors say they are charged a front end sales load, even though most bank mutual funds include this fee.

The misperceptions about FDIC coverage that our survey reveals are widespread throughout the population of bank customers. Even though our analysis shows that there are differences in knowledgeability about FDIC coverage by gender, education and income, we find no subgroup of bank customers where most people are clearly aware of the limitations of FDIC coverage.

There is one demographic difference worth mentioning, however. From our data, it seems banks are marketing uninsured investment products more aggressively to older people. Half of the bank customers over age 65 but just a third of younger customers say they were contacted by their bank about purchasing a mutual fund.

One final note, bank customers trust their banks to give them good information. Eighty-eight percent feel they've never been misled or misinformed by their bank. Few, only 5 percent, would contact any government agency if they had a problem with their bank.

Most, 82 percent, would deal directly with the bank and few could name a source of help other than a bank employee when pressed to think about how they personally would handle a problem concerning their own bank investments or accounts.

Thank you.

[Testimony resumes on p. 247.]

[The survey referred to follows:]

Bank Investment Products Survey
January 1994

Conducted for:

The American Association of Retired Persons
The North American Securities Administrators Association

Conducted by:

PRINCETON SURVEY RESEARCH ASSOCIATES

Princeton Survey Research Associates
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Consumers may not have caught up with all of the changes in the financial marketplace. While banks have diversified their activities and now offer an array of financial products like mutual funds and stocks, many consumers still cling to older notions about the safety of bank accounts. In this new climate, many Americans have falsely concluded that the FDIC offers the same protection to mutual funds, stocks, and annuities offered by banks that it offers to savings and checking accounts. Only a minority of commercial bank customers understand that products like mutual funds, stocks, annuities, and government bonds that are sold at banks are not FDIC-insured.

These are some of the findings from a recent study by Princeton Survey Research Associates, which explores what financial decision-makers who use commercial banks understand about FDIC insurance, and uninsured products like mutual funds and annuities sold by banks. Major findings include:

- While most commercial bank customers say that they understand costs and rules associated with their bank accounts, fewer say they understand the financial risks associated with these accounts.

- Fewer than one in five commercial bank customers (whose banks offer these products) understands that government bonds, mutual funds, or annuities are uninsured. Three-quarters (75%) of commercial bank customers whose bank sells stocks do not realize these are uninsured.

- There is a gender gap on knowledge of financial risk: Men are twice as likely as women to know that stocks, mutual funds, and annuities are not FDIC-insured.

- Customers who have bought mutual fund or annuities at their bank are not better informed about FDIC insurance, and are even somewhat more likely to think that mutual funds and annuities are insured.

- Over a third (36%) of consumers who bought a mutual fund had not spoken with anyone at their bank about the appropriateness of this kind of investment.

- Many consumers who bought mutual funds through a commercial bank are unaware of the costs and fees that banks charge them. Only 36% of mutual fund owners say they are paying front-end sales loads, although most bank mutual funds charge this fee.

- Americans continue to trust their banks: 88% say they have always received good information about the risk of bank investments from their bank.

- Banks seem to market uninsured investment products more aggressively to older Americans. Almost half of bank customers age 65 and older, but just a third of younger customers, have been contacted by their banks about investing in mutual funds.

These are some of the findings from a study of 1,000 financial decision makers who presently have a relationship with a commercial bank. Princeton Survey Research Associates conducted a telephone survey study from October 14 to October 31, 1993 on behalf of the American Association of Retired Persons and the North American Securities Administrators Association in order to investigate Americans' current level of understanding about banking products and FDIC insurance.

TODAY'S FINANCIAL MARKETPLACE

Today's financial decision-makers have relationships with several different institutions apart from their commercial bank. Almost half (48%) report using a savings bank, over a third report using a savings and loan company (35%), and 38% report using a credit union. One in four commercial banking customers also uses a mutual fund company and one in five (21%) uses a brokerage company. Financial decision-makers therefore must sift through a variety of rules and fee structures in order to handle the demands of the current marketplace.

Relationships With Financial Institutions

(Base = Total Sample of Commercial Bank Customers)

	Percent Who Use For Banking and Investments
Credit Union	38
Brokerage Company	21
Mutual Fund Company	25
Insurance Company	30
Savings & Loan Company	35
Savings Bank	48
Commercial Bank	100
	(n=1,000)

Consumers may not have caught up with all of the complexities in this diversified environment. While almost all respondents know their bank offers checking, savings and

certificates of deposit, considerable numbers remain confused as to whether their bank offers financial products like stocks and bonds. Over a third (35%) do not know if their bank sells mutual funds or stocks, and 42% do not know if their bank sells annuities. Twenty-eight percent cannot say whether their bank sells government bonds.

Awareness of Banking Products

(Base= Total Sample of 1,000 Commercial Bank Customers)

Does your bank offer...?

	Yes %	No %	Don't Know %
Checking Accounts	100	*	*
Savings Accounts	99	1	*
Certificates of Deposit	92	3	5
Money Market Accounts	80	6	14
Government Bonds	63	9	28
Mutual Fund Accounts	49	16	35
Annuities	44	14	42
Stocks	30	35	35

*less than 0.5%

Whatever else has changed, Americans still place a special trust in their banks. This confidence expresses itself in several ways. A strong majority (88%) feel their banks have

ı them good information about their investments; only 4% feel have been misled or misinformed. Given their faith in s, most (82%) consumers say they would contact their own bank hey experienced a problem with any of their accounts or stments, rather than contacting other sources. Very few umers say that they would contact a government agency in this ation.

Some of this trust is also reflected in consumer attitudes t banking costs and regulations. Most (82%) report it is to understand the different fees and rates that their bank ges. Three quarters think it is easy to understand the rules regulations applying to different accounts and services.

Even while consumers express trust in banks, they are less fortable with their own understanding of financial risk. er consumers (57%) say it is easy to understand the financial ks involved in making different kinds of investments through ir bank. Older consumers are even more uneasy about this ue: only half of the consumers over 65 years of age report s vs. 59% for younger bank customers.

Do you think it is easy or hard to understand . . . ?

(Base = Total Sample of 1,000 Commercial Bank Customers)

	Easy %	Hard %	Don't Know %
Financial risks involved in making different kinds of investments through your bank	57	25	18
The rules and regulations that apply to different accounts and services your bank offers	75	21	4
The different fees and rates your bank charges for their services	82	16	2

DO AMERICANS UNDERSTAND THE FDIC?

The Federal Deposit Insurance Corporation protects the value of bank deposit accounts up to $100,000. The FDIC insures certificates of deposits, and savings and checking account deposits. On the other hand, financial instruments based upon debt or equity are not insured by the government.

Most financial decision makers (92%) are aware of the FDIC, and this awareness is linked to income, education, and gender. Almost all (97%) of the college graduates have heard of the FDIC, while only 71% of those without a high school diploma have heard of it. Men and higher-income respondents are also more likely to have heard of the FDIC.

Before today had you heard of the FDIC?

(Base = Total Sample of Commercial Bank Customers)

	Yes %	No %	N
Total	92	8	(1,000)
Household Income			
Less than $20,000	86	14	(172)
$20,000-$39,999	93	6	(313)
$40,000-$59,999	97	3	(187)
$60,000 and over	98	2	(191)
Education			
No high school	71	29	(64)
No college	89	10	(665)
College	97	3	(328)

As we have seen, most consumers express faith in banks and appear confident about their understanding of the rules and regulations governing their accounts. However, consumers are confused about FDIC insurance. Many believe the FDIC program offers much broader protection to bank products than it actually does -- protection extending to bonds, mutual funds, and stocks. This suggests that many bank investors may have a false confidence in the security of their bank investments.

<u>If we consider our survey questions as a kind of financial awareness test, then most financial decision-makers have failed it.</u> We asked only those respondents whose bank offered a specific product (e.g., market accounts) if the FDIC insured that

product. In other words, this was not an abstract question -- but a real measure of how well customers understand products offered by their own commercial bank. We should stress that this was a conservative analysis since consumers who are unaware of what their bank offers (and therefore are even less knowledgeable) were not tested on their understanding of whether FDIC insurance applies to these particular bank products.

The answers reflect a surprising ignorance about financial risk: most respondents either do not know or give the wrong answer about FDIC protection of uninsured products -- far outnumbering the "correct" responses:

> Only 14% of those whose banks sell government bonds realize that these are uninsured, while 47% incorrectly report that bonds are FDIC-insured, and another 39% do not know.

> Considering respondents whose banks sell mutual funds, only 18% know that these are not FDIC-insured. Thirty-nine percent incorrectly report mutual funds offered by banks as FDIC-insured, and another 43% do not know whether mutual funds from their banks are insured.

Does FDIC insure product?

(Base = Own Bank Offers Product)

	Yes %	No %	Don't Know %	N
Checking Accounts	79	5	16	(993)
Savings Accounts	86	1	13	(989)
Certificates of Deposit	71	3	26	(921)
Money Market Accounts	56	10	34	(814)
Government Bonds	47	14	39	(636)
Mutual Fund Accounts	39	18	43	(496)
Annuities	40	14	46	(445)
Stocks	35	25	40	(305)

It is reasonable to think that people who actually bought mutual funds from their bank would be better informed -- because they have real experience with the product. On the contrary, those who bought mutual funds from their commercial bank are somewhat more likely to give the wrong answer: 52% say their mutual funds are FDIC-insured. Only 17% of mutual fund owners realize their accounts are not FDIC-insured.

The situation is similar for annuities: those who have bought annuities from a bank are no better informed than other people (and in fact are slightly less informed). Among owners of

annuities, 55% claim incorrectly that these are FDIC-insured, and only 17% realize their accounts are uninsured. By comparison, 40% of all respondents whose banks sell annuities say annuities are insured.

One group that might be expected to be especially well-informed are consumers who have direct relationships with brokerage and mutual fund companies, and therefore, might be more experienced investors. Indeed, these consumers do know more about FDIC insurance -- and are about three times as likely to give the correct answer about FDIC coverage of mutual funds, stocks and annuities. However, while the differences are striking, even these investors are hardly savvy -- the majority still fail to understand that the FDIC program does not cover these bank investments.

Experience With Brokerage and Mutual Fund Companies

(Base = Own Bank Offers Product)

	Use Brokerage/ Mutual Fund Company	Don't Use Brokerage/ Mutual Fund Company
Does the FDIC insure...		
Government Bonds (n=636)		
Yes	44	48
No	22	10
Don't know	34	42
Mutual Fund Accounts (n=496)		
Yes	35	41
No	33	11
Don't know	32	48
Annuities (n=445)		
Yes	32	44
No	26	8
Don't know	42	48
Stocks (n=305)		
Yes	20	43
No	48	13
Don't know	32	44

The same is true for consumers with higher education and higher income: they are more knowledgeable than other consumers, but still are largely misinformed. For example, college graduates are twice as likely as those with lower educational attainment to say annuities are uninsured. Twenty-two percent of college graduates report this, while only 11% of others report this. Still, the fact remains that most college graduates and higher income respondents fail to correctly understand how the FDIC program operates. Low-income Americans (under $20,000 in household income) know the least about FDIC insurance. Fewer than one in ten low-income Americans understand that products like mutual funds and stocks are not FDIC-insured.

Does FDIC Insure Product by Income and Education?

(Base = Own Bank Offers Product)

Percent Who Know Each Product is Not FDIC-insured

	Gov't Bonds %	Mutual Funds %	Annuities %	Stocks %
Household Income				
Less than $20,000	7	7	4	7
$20,000-$39,999	11	14	14	18
$40,000-$59,999	13	21	12	33
$60,000 and over	28	33	25	49
Education				
Not a college graduate	11	14	10	19
College graduate	22	27	21	41

There is also a gender gap on this issue. Men are more than twice as likely to know the limitations of the FDIC program. For example, 29% of men know that bank mutual funds are not FDIC-insured, compared to only 10% of women. Thirty-nine percent of men know stocks purchased at a bank are uninsured, while only 15% of women know this. A mere 5% of widowed or divorced women realize that stocks offered by their banks are uninsured.

Effect of Gender on Knowledge of Uninsured Financial Products

(Base = Own Bank Offers Product)

Percent Who Know Each Product is Not FDIC-insured

	Men %	Women %
Government Bonds	20	9
Mutual Fund Accounts	29	10
Annuities	20	9
Stocks	39	15

Most financial decision makers are well informed about bank investment products that are insured. Among respondents whose banks offer these products, most know checking accounts (79%) savings accounts (86%) and certificates of deposit (71%) are insured. Money market accounts are more confusing to people: a third (34%) do not know whether they are FDIC-insured.

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MUTUAL FUNDS AND ANNUITIES

Banks have made inroads in selling their customers a variety of financial products. The majority of commercial bank customers report having either a checking account (95%) or a savings account (82%) at their commercial bank; 43% say that they have a certificate of deposit. A quarter report having a money market fund, and almost as many (23%) report purchasing a government bond through their bank. Few respondents have invested in mutual funds (6%), stocks (5%), or annuities (3%) at their commercial bank. Among those reporting that their bank sells these products, 12% have bought mutual funds, and 8% have bought annuities.

Financial Products Purchased at Commercial Banks

(Base = Total Sample of Commercial Bank Customers)

Have you personally purchased...?

	%
Checking Accounts	95
Savings Accounts	82
Certificates of Deposit	43
Money Market Accounts	25
Government Bonds	23
Mutual Funds	6
Annuities	3
Stocks	5
Number of Interviews	(1,000)

Income is not the determining factor in who buys uninsured financial products from a bank. Poorer consumers (household income under $20,000) are just about as likely to invest in higher-risk bank products like stocks, annuities and mutual funds as consumers with more income. As we have seen, very few of these poorer consumers understand that their investment is not protected by the FDIC.

Financial Products Purchased at Commercial Banks

(Base = Total Sample of Commercial Bank Customers)

	Household Income			
	Less than $20,000 %	$20,000-$39,999 %	$40,000-$59,999 %	$60,000 or More %
Checking Account	96	97	95	97
Savings Accounts	77	86	86	85
Certificate of Deposit	38	35	42	56
Money Market Account	17	22	25	33
Government Bonds	25	24	20	24
Mutual Funds	5	6	4	7
Annuities	3	2	4	6
Stocks	4	3	5	7
Number of Interviews	(172)	(313)	(187)	(191)

Older (over 65 years) consumers are more likely than younger consumers to report buying government bonds, money market accounts, certificates of deposit, and stocks from their commercial bank.

Financial Products Purchased at Commercial Banks

(Base = Total Sample of Commercial Bank Customers)

	Age	
	18 to 64	65 and older
Government Bonds	21	31
Money Market Account	22	37
Mutual Funds	6	5
Checking Account	95	97
Certificate of Deposit	40	57
Annuities	4	3
Stocks	4	10
Savings Accounts	83	79
Number of Interviews	(842)	(140)

Most consumers decide to buy mutual funds or annuities from banks either on their own or through a personal financial advisor. However, some are brought into the market directly by their bank, either through a bank officer, a bank teller, or some other bank employee.

Of those who are aware that their bank sells mutual funds, over a third (34%) say they were contacted by their bank about investing in the bank's mutual fund. Most (80%) of this contact is by mail, although 15% of respondents were solicited by telephone and another 5% by personal visits. People age 65 and older are contacted by their banks about buying mutual funds more often than younger people. About half of older bank customers (47%), but just a third of younger customers (32%) say their bank contacted them about mutual funds.

Mutual funds can be a risky investment, and are not appropriate for everyone. However, not all investors are obtaining advice from their banks. <u>While over half (57%) of mutual fund owners had talked with someone at their bank about the appropriateness of investing in mutual funds, more than a third (37%) say that no one had spoken with them.</u> Another 7% could not remember.

Can you remember who initially advised you to invest in a mutual fund/annuity at your bank?

(Base = Bank Mutual Fund & Annuity Owners)

	Mutual Fund Owners	Annuity Owners
	%	%
Own decision	41	49
Financial advisor	14	21
Bank officer	15	10
Bank teller	2	3
Other bank employee	6	3
Other	6	3
Number of Interviews	(60)	(34)

Has your bank ever contacted you to ask if you wanted information about mutual funds or to see if you wanted to purchase a mutual fund?

(Base = Own Bank Offers Mutual Funds)

	Total	Mutual Fund Owners
	%	%
Yes	34	39
No	62	56
Don't know	4	5
Number of Interviews	(488)	(60)

How were you contacted?

Telephone	15	20
Personal visit	5	0
Mail	80	72
Other	10	22

Bank Guidance in Mutual Fund & Annuity Investments

(Base = Have Purchased Mutual Funds or Annuities at Own Bank)

	Mutual Fund Owners %	Annuity Owners %
Before you invested, did someone at your bank talk with you about your investment and its appropriateness for you?		
Yes	57	57
No	36	38
Don't know	7	5
Did your bank give you any written disclosure or any information describing the risks of this kind of investment?		
Yes	85	63
No	10	25
Don't know	5	12
	(60)	(34)

Most banks provide written disclosures about mutual funds and annuities to their customers. Eighty-five percent of mutual fund owners say their bank had given them a written statement, and 63% of annuity owners say the same. More than three quarters of consumers read these materials although, as we have seen, their understanding of these disclosures was limited.

Banks charge customers for these accounts in a variety of ways -- but many customers are unaware of the fees their banks charge. The picture that emerges is that customers who go to banks for mutual fund and annuity purchases are not competitive shoppers. For example, while many mutual fund companies offer "no-load" funds, most banks charge a front end sales load. Only 36% of bank mutual fund owners are aware of this. A third of these owners say that they do not know about this, but the rest think that they have avoided these sales loads. Almost half report that they are being charged redemption fees (46%), while 29% do not know. And, 38% report that they pay asset management fees, while 26% do not know.

Annuity owners are similarly confused about their fees. About a third do not know if they are charged a sales load (36%) or insurance expense (32%), and 43% do not know if they are charged an asset management fee.

Mutual Fund Charges and Fees

(Base = Have Purchased Mutual Funds or Annuities at Own Bank)

Does your bank charge the following:

	Mutual Fund Owners (n=60)
Front-end sales load	
Yes	36
No	32
Don't know	32
Redemption Fee	
Yes	46
No	25
Don't know	29
Management Fee	
Yes	38
No	36
Don't know	26

	Annuity Owners (n=34)
Front-end sales load	
Yes	32
No	32
Don't know	36
Maintenance Fee	
Yes	34
No	42
Don't know	24
Asset Management Fee	
Yes	14
No	43
Don't know	43
Surrender Fee	
Yes	49
No	25
Don't know	26
Insurance Expense	
Yes	30
No	38
Don't know	32

Given the fact that consumers are often unaware of the cost of their investments, it is not surprising that most bank mutual fund and annuity owners are not disturbed by costs and fees that banks charge. Most of the mutual fund and annuity owners report that bank fees and costs are either about what they expected, or lower than they expected. However, a third (33%) of mutual fund owners say the costs and fees associated with their mutual fund are higher than they expected.

Did the costs and fees for your (mutual fund/annuity) turn out to be about what you expected, higher than expected, or lower than expected?

	About as Expected %	Higher %	Lower %	N
Mutual Fund Owners	47	33	10	(60)
Annuity Owners	60	13	6	(34)

STUDY METHODOLOGY:

This survey was conducted by Princeton Survey Research Associates of Princeton, New Jersey on behalf of the American Association of Retired Persons and the North American Securities Administrators Association. The results are based upon telephone interviews with a representative sample of 1,000 adults living in the continental United States who reported making the financial decisions for their household, and who also reported using a regular commercial bank. Interviews were conducted during the period October 14 to October 31, 1993.

After being combined with the subsample of households whose financial decision-makers did not report using a regular commercial bank, these data were weighted to reflect general U.S. household characteristics. The margin of sampling error for the total sample of 1,000 commercial bank customers is plus or minus 3 percentage points at the 95 percent level of confidence. Question wording and the practical difficulties of conducting surveys can also introduce error or bias into survey results.

APPENDIX

Top-line Questionnaire

Bank Investment Products Survey

Princeton Survey Research Associates for
The American Association of Retired Persons and
The North American Securities Administrators Association

10/14/93

Top-line Questionnaire

N=1,000 financial decision-makers who use a commercial bank

Margin of Sampling Error: ± 3 percentage points

Interviewing Dates: October 14-31, 1993

THERE IS NO Q1

2. First, as I read a list of different kinds of financial institutions, please tell me whether or not you use each type for your own banking and investments.

	Yes %	No %	Don't Know %
a. A credit union	38	62	*
b. A brokerage company	21	78	1
c. A mutual fund company	25	75	*
d. An insurance company that offers investment products	30	68	2
e. A savings and loan company	35	64	1
f. A savings bank (NOTE: These have the word "savings" in their name.)	48	52	*
g. A regular commercial bank (NOTE: These are any other kind of bank not included in the previous categories.)	100	0	0

IF MORE THAN ONE YES TO Q2: For these next questions I'd like you to think about the regular commercial bank that you use most often.

THERE IS NO Q3

4. I'd like you to tell me whether it is easy to understand the different kinds of accounts and services available from your bank. For each of the following, please tell me whether you think it is easy or hard to understand. First, . . .

		Easy %	Hard %	Don't Know %
a.	the different fees and rates that your bank charges for their services	82	16	2
b.	the financial risks involved in making different kinds of investments through your bank	57	25	18
c.	the rules and regulations that apply to different accounts and services that your bank offers	75	21	4

5. As far as you know, does your bank offer each of the following products, or not? (DO NOT ROTATE) (NOTE: IF ANOTHER COMPANY SELLS ITS PRODUCTS ON THE BANK'S PREMISES, PLEASE COUNT THIS AS A "YES" BECAUSE THE PRODUCT WAS PURCHASED AT THE BANK.)

	Yes %	No %	Don't Know %
a. government bonds	63	9	28
b. money market accounts	80	6	14
c. mutual fund accounts	49	16	35
d. checking accounts	100	*	*
e. certificates of deposit	92	3	5
f. annuities	44	14	42
g. stocks	30	35	35
h. savings accounts	99	1	*

6. The Federal Deposit Insurance Corporation, or FDIC, is a government agency that guarantees the accounts of people who deposit money in banks. Deposits of up to $100,000 are protected through this program. Before today, had you heard of the FDIC program?

92	Yes have heard of it before
8	No
*	Don't know
100	

7. (ASK FOR EACH "YES" RESPONSE IN Q5) And, as far as you know, does the FDIC insure each of the following savings and investment accounts your bank offers, or not?

	Yes %	No %	Don't Know %
a. government bonds	47	14	39
b. money market accounts	56	10	34
c. mutual fund accounts	39	18	43
d. checking accounts	79	5	16
e. certificates of deposit	71	3	26
f. annuities	40	14	46
g. stocks	35	25	40
h. savings accounts	86	1	13

8. As far as you know, is there any other insurance program that protects the value of (INSERT) at your bank?
[Combined Responses for Q.7 and Q.8 based on "yes" to Q. 5]

	Yes, Either FDIC or Other %
a. government bonds	48
b. money market accounts	56
c. mutual fund accounts	40
d. checking accounts	79
e. certificates of deposit	71
f. annuities	41
g. stocks	36
h. savings accounts	86

9. And, which of the following accounts and investments, if any, have you personally purchased at your bank? Do not include accounts or investments you purchased at other financial institutions. (DO NOT ROTATE) (NOTE: IF ANOTHER COMPANY SELLS ITS PRODUCTS ON THE BANK'S PREMISES, PLEASE COUNT THIS AS A "YES" BECAUSE THE PRODUCT WAS PURCHASED AT THE BANK.)

	Yes	No	Don't Know/ Refused
	%	%	%
a. government bonds	23	77	*
b. money market accounts	25	74	1
c. mutual fund accounts	6	93	1
d. checking accounts	95	4	1
e. certificates of deposit	43	56	1
f. annuities	3	96	1
g. stocks	5	95	*
h. savings accounts	82	17	1

10a. (IF "NO" TO Q9c) As you may know, mutual funds are companies that invest your money in many different stocks and bonds. Has your bank ever contacted you to ask if you wanted information about mutual funds, or to see if you wanted to purchase a mutual fund?

34	Yes
62	No
4	Don't know
100	

10b. (IF "YES" TO Q9c) Before you purchased the mutual fund at your bank, had the bank ever contacted you to ask if you wanted information about mutual funds, or to see if you wanted to purchase a mutual fund?

39	Yes
56	No
5	Don't know
100	

10c. (IF "YES" TO Q10a OR Q10b) And how were you contacted by your bank? Was it by telephone, a personal visit at home, or was it by mail?

15	Telephone
5	Personal visit at home
80	By mail
10	Other (VOLUNTEERED)
1	Don't know
111*	

*Multiple responses

IF NOT "YES" TO Q9c, SKIP TO Q15

10d. (IF OWN A MUTUAL FUND, "YES" TO Q9c) Can you remember who initially advised you to invest in the mutual fund account at your bank? Was it a bank teller, a bank officer, a personal financial advisor, someone else, or is this something you decided to invest in on your own?

2	Bank teller
15	Bank officer
6	Other bank employee (VOLUNTEERED)
14	Financial advisor
6	Other (SPECIFY)
41	Own decision
16	Don't know
100	

11. (IF OWN A MUTUAL FUND) Thinking back to when you first invested in a mutual fund at your bank, did someone at the bank talk with you about your investment goals, your income, and whether a mutual fund is suitable for you?

57	Yes
36	No
7	Don't know
100	

12. (IF OWN A MUTUAL FUND) Did your bank give you any written disclosure concerning your mutual fund, or any material that describes the risk of this kind of investment?

85	Yes
10	No
5	Don't know
100	

13. (IF YES TO Q12) Did you read the material your bank gave you?

86	Yes
11	No
3	Don't know
100	

14. (IF OWN A MUTUAL FUND) Now I'd like to ask you about the costs and fees that may be associated with the mutual fund at your bank. As far as you know, which of the following fees are part of your mutual fund? (IF MORE THAN ONE BANK MUTUAL FUND, ASK ABOUT THE ONE PURCHASED MOST RECENTLY)

		Yes	No	Don't Know
		%	%	%
a.	A front-end sales load?	36	32	32
b.	A redemption fee?	46	25	29
c.	A management fee?	38	36	26

14a. (IF OWN A MUTUAL FUND) Did the costs and fees for your mutual fund turn out to be about what you expected, higher than expected, or lower than expected?

47	About as expected
33	Higher
10	Lower
10	Don't know
100	

14b. (IF OWN A MUTUAL FUND) Was this the first time you'd invested in a mutual fund, or had you invested in mutual funds before you purchased the fund at your bank?

50	First time
45	Invested in mutual funds before
2	Don't know
3	Refused
100	

IF NOT "YES" TO Q9f, SKIP TO Q20
IF ANSWERED MUTUAL FUND QUESTIONS, Q10b TO Q14b, READ BEFORE Q15: Now I have a few questions about the ANNUITY you purchased at your bank.

15. (IF OWN AN ANNUITY, "YES" TO Q9f) Can you remember who initially advised you to invest in an annuity at your bank? Was it a bank teller, a bank officer, a personal financial advisor, someone else, or is this something you decided to invest in on your own?

3	Bank teller
10	Bank officer
3	Other bank employee (VOLUNTEERED)
21	Financial advisor
3	Other (SPECIFY)
49	Own decision
11	Don't know
100	

16. (IF OWN AN ANNUITY) Thinking back to when you first invested in an annuity at your bank, did someone at your bank talk with you about your investment goals, your income, and whether an annuity is suitable for you?

57	Yes
38	No
5	Don't know
100	

17. (IF OWN AN ANNUITY) Did your bank give you any written disclosure concerning your annuity, or any material that describes the risk of this kind of investment?

63	Yes
25	No
12	Don't know
100	

18. (IF YES TO Q17) And, did you read the material your bank gave you?

77	Yes
15	No
8	Don't know
100	

. (IF OWN AN ANNUITY) Now I'd like to ask you about the costs and fees that may be associated with the annuity at your bank. As far as you know, which of the following fees are part of your annuity? (IF MORE THAN ONE BANK ANNUITY, ASK ABOUT THE ONE PURCHASED MOST RECENTLY)

	Yes %	No %	Don't Know %
A front-end sales load?	32	32	36
A maintenance fee?	34	42	24
An asset management fee?	14	43	43
A surrender fee?	49	25	26
Insurance expense?	30	38	32

)a. (IF OWN AN ANNUITY) Did your annuity's costs and fees turn out to be about what you expected, higher than expected, or lower than expected?

60	About as expected
13	Higher
6	Lower
21	Don't know
100	

0. (IF ANY "YES" TO Q9) If you ever were to have a complaint, question, or problem with ANY of the accounts or investments you have at your bank, whom would you contact to complain or get more information? (REQUIRED PROBE UNTIL NO ANSWER: Anyone else?) (RECORD ALL MENTIONS)

82	Bank
11	Personal financial advisor
4	Friend or relative
5	Personal lawyer
5	Government agency (local, state or federal)
4	Consumer organization
5	Other (SPECIFY)
5	Don't know
121*	

*Multiple responses

21. In general, do you believe your bank has ever misled or misinformed you about the risks involved with your bank accounts or investments, or do you believe your bank has given you good information about investment risks?

4	Misled or misinformed
88	Good information
5	Never got this information from bank (VOLUNTEERED)
3	Don't know
100	

22. (IF "MISLED" TO Q21) Who at the bank misled or misinformed you?

15	Bank teller
39	Bank officer
13	Other bank employee (SPECIFY)
0	Financial advisor
13	Bank brochures or other written materials
6	Other (SPECIFY)
25	Don't know
111*	

*Multiple responses

23. Finally, I'd like to ask you just a few questions for statistical purposes only. Are you now married, living as married, widowed, divorced, separated, or are you single?

59	Married
2	Living as married
9	Widowed
12	Divorced
1	Separated
16	Single
1	Refused
100	

24. What is your age?

14	18-29
48	30-49
21	50-64
15	65 and over
2	Undesignated
100	

25. What is the last grade or class you completed in school?

7	Less than high school graduate (Grade 11 or lower)
28	High school graduate (including GED certificate)
4	Technical, trade, or business school after high school
27	Some college or university, but no 4-year degree
26	College or university graduate (BA, BS, or other 4-year degree received)
7	Post-graduate or professional schooling after college (including work towards an MA, MS, Ph.D, JD, DDS or MD)
1	Refused
100	

26. What is your race? Are you white, black, Asian, or some other race?

89	White
7	Black or African-American
1	Asian
1	Other or mixed race
2	Refused
100	

27. Are you now working at a paid job full time, part time, or are you not employed?

59	Full time
10	Part time
7	Unemployed or laid off
14	Retired
1	Disabled
4	Homemaker
1	Student
3	Other
1	Refused
100	

27a. Are there any children under the age of 18 who live in your household?

36	Yes
63	No
1	Refused
100	

27b. And, how many adults age 18 or older, including yourself, live in your household?

27	One
57	Two
11	Three
4	Four or more
1	Refused
100	

28. Approximately what is your annual total family income BEFORE taxes-- just tell me when I get to the right category.

8	Less than $10,000
15	$10,000 to under $20,000
13	$20,000 to under $30,000
13	$30,000 to under $40,000
19	$40,000 to under $60,000
15	$60,000 to under $100,000
5	$100,000 or more
3	Don't know
9	Refused
100	

Thank you very much for your time. Have a nice (day/evening).

RECORD SEX

44	Male
56	Female
100	

TESTIMONY OF CHRIS LEWIS

Mr. LEWIS. I am Chris Lewis, Director of Banking and Housing Policy with the Consumer Federation of America. And CFA greatly appreciates the opportunity today to testify before the subcommittee on the subject matter of bank sales of mutual funds and other uninsured investment instruments and the proposed merger of the Mellon Bank Corp. and the Dreyfus Corp.

This merger, as I note in my written statement, now pending before various banking regulatory agencies, raises a number of critical public policy concerns. And chief among them from the perspective of the CFA is the certain increase, we believe, in consumer confusion about the degree of risk of investment products sold on the premises of insured institutions.

As one trade publication recently noted, the proposed merger "highlights all that's troubling about banks in the mutual fund business."

And, Mr. Chairman, we obviously appreciate the seriousness with which you and other members of the subcommittee and the full committee view the legal and public interest implications of this merger, and banks continued entry into the securities business.

Over the past two decades, creative interpretations of the Glass-Steagall Act by banking regulators have permitted vastly expanded bank involvement in the mutual fund and other securities lines of business. We believe that the current head-long rush of the banking industry into the retail mutual fund business must be placed in perspective.

First, we know of no clamor by consumers for further expansion by banks into the mutual fund business. We monitor consumer demands nationwide and the organization is not aware of a consumer push for more mutual fund outlets, either operated by banks or other entities.

Second, we are aware that the banking industry enjoyed record profits last year as in the previous year. And there seems to be no emergency need to open new lines of business to protect the earnings of the banking industry.

Third, we are aware, as other witnesses have just testified, that there is widespread confusion among the public about the nature of risk associated with investment products, including mutual funds, peddled by banks.

Fourth, the Congress, through bills introduced by yourself and the chairman of the Banking Committee, is attempting to establish specific statutory guidelines to end the confusion among the banks, among the regulators, and most importantly among the investing public.

As others have testified, we believe, Mr. Chairman, that the banks' mutual fund sales practice currently at play in the marketplace are all too often designed to lead the unsuspecting customer into believing that good old Uncle Sam and the taxpayers are guaranteeing the investments.

In short, we believe the protective shield to the FDIC, long symbol of security for millions of American consumers, is being tarnished by bankers hell bent on becoming big time players in Wall Street's mutual funds markets.

The banking industry as well as the Congress and the American public, we believe, should want that shield protected. Certainly, the full faith and credit of the U.S. taxpayers symbolized by the FDIC logo should not be utilized by banks as a means, directly or indirectly, of duping consumers into believing that investments in the stock market are risk free.

And I do note in my written statement that we believe the facts are clear that we have a very serious problem here and that we do not need to go about studying whether or not there is a problem here. We do have a problem, we have a very serious problem. Which leads us to ask, what are the banking regulators doing to address this problem?

And I note in my statement that last month the Washington Post quoted data from the American Bankers Association, data that noted that the four agencies had produced four different answers about the seriousness of the confusion created by mutual funds bearing the identical or similar name of an insured bank. Two weeks ago, the banking agencies faced with mounting publicity and with the prospect of action by this and other committees finally decided that they were all part of the same government and came up with an interagency statement on retail sales of nondeposit investment products.

We believe that what has emerged in this "policy statement" is a set of lowest common denominators with "should" not "shall" the operative verb. And in a number of critical areas the interagency statement does not correct egregious practices.

Rather, and unfortunately it institutionalizes them. For example, on page 8 of the interagency statement, the regulators endorse the use of promotional brochures and advertising where both uninsured and insured products are advertised together beside one another. The agencies only suggest that the material "clearly segregate the information."

But we don't know what this means, nor does the interagency guidance statement provide any detail what this means. Two spaces between the two distinctly different products, or on separate pages of the same brochure? It is unclear and we believe that this is very reckless guidance.

The two products, insured and uninsured, should not appear in the same advertisement or in the same promotional brochure.

On the critical matter of the separation of personnel, the agencies provide a road map, we believe, for the banks to make full utilization of personnel across the lines of insured and uninsured products. The interagency statement allows personnel, which handle insured deposits, to recommend investment products.

The previous panel talked at great length about the conflicts of interest of having tellers and other personnel that handle insured products recommend the subdebt of ACC and Lincoln Savings.

And if this is not enough, the interagency statement permits tellers to be paid "nominal fees" to encourage the referral of customers for nondeposit investment products. And now, we wonder, does the teller urge the consumer to play it safe or to forego government insurance and invest in some of those securities being sold across the lobby. Given human nature and the generally low pay of tellers,

you can make a pretty sure bet that the payment of referral fees cannot but steer the savings of consumers in the direction of risk.

In short, we believe the regulators at this point have failed to face up to the full realities of the problem in the marketplace. While the banks have roared forward and while the consumer has been left in a sea of confusion about the status of government insurance, the regulators continue to encourage questionable practices by the banking industry, dangerous practices that put hard-earned savings of consumers at risk.

And we believe, Mr. Chairman, given that the Congress has created the deposit insurance system, the Congress has an obligation to enact safeguards to protect not only the consumer but the integrity of the FDIC shield.

Thanks to the Congress's support of FDIC deposit insurance, consumers don't think twice about the safety of savings once placed in the hands of a banker. The bankers know that and have enjoyed the competitive advantages of a taxpayer-backed insurance system. It is the Congress, we believe, that must take responsibility and enact legislation that will ensure that there can be no commingling in practice or perception of insured and uninsured activities of banks.

My statement highlights the elements of consumer protections that we have endorsed with our consumer and regulatory colleagues here with us today. I won't elaborate on them orally, except to note that we do strongly endorse the need for functional regulation of the securities activities of banks which is the principal thrust of your legislation, H.R. 3447.

And, until proven protections are in place, and I emphasize proven, we need to make sure that the safeguards are working. We believe that it would be reckless for banking regulators to add to the problem by allowing banks to further expand into the securities business as is proposed by the current Mellon-Dreyfus merger.

We call, therefore, Mr. Chairman, for a moratorium on further expansion of bank operations into the mutual fund and related securities businesses, unless and until the Congress has a chance to enact strong statutory safeguards, second that the banking and securities regulators come up with consistent, coordinated and proven approaches to address the province of consumer confusion and, thirdly, that the banking industry itself get its act together and eliminate the practices, however subtle, that permit visions of government insurance to dance in the public's mind.

And I would be glad to answer any questions.

[The prepared statement of Mr. Lewis follows:]

Consumer Federation of America

STATEMENT OF CHRIS LEWIS
DIRECTOR OF BANKING AND HOUSING POLICY
CONSUMER FEDERATION OF AMERICA

ON

COMMERCIAL BANK SALE OF MUTUAL FUNDS
AND THE MERGER OF
MELLON BANK CORPORATION AND THE DREYFUS CORPORATION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE
COMMITTEE ON ENERGY AND COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

HONORABLE JOHN D. DINGELL
CHAIRMAN

MARCH 2, 1994

The Consumer Federation of America appreciates the opportunity to testify before the Subcommittee today on the subject of bank sale of mutual funds and the proposed merger of Mellon Bank Corporation and the Dreyfus Corporation.

This merger -- now pending before the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Office of Thrift Supervision -- raises a number of critical public policy concerns -- among them the certain increase of consumer and investor confusion about the nature of risk of investment products sold on the premises of insured depository institutions.

As one trade publication recently noted, the proposed merger "highlights all that's troubling about banks in the mutual fund business".[1]

The significance of this transaction for consumer protection

[1] **American Banker**, February 8, 1994, p. 26.

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and the integrity of financial markets cannot be overemphasized. States one securities industry analyst: "This deal has the potential to have a greater impact on the bank investment market than any previous merger. It's unprecedented."[2]

Mr. Chairman, CFA appreciates the seriousness with which you view the legal and public interest implications of this merger. It is our hope that the Subcommittee's hearings will focus the attention of regulatory officials on the need to keep the public interest -- not the bankers' interest -- foremost in their mind when they review industry demands for increased securities powers for insured financial institutions.

BACKGROUND

Over the past two decades, creative interpretations of the Glass-Steagall Act by banking regulators have permitted vastly expanded bank involvement in the mutual fund and other securities business activities. This Committee certainly does not need to be reminded that the erosion of the distinction between commercial and investment banking -- ushered in by the banking industry's regulators -- does <u>not</u> represent a new way of conducting the very old business of banking. These are wholly distinct financial activities.

CFA believes that the current headlong rush by the banking industry into the retail mutual fund business must be placed in proper perspective.

First, there is no known clamor by consumers for further expansion by banks into the mutual fund business. CFA monitors consumer demands nationwide and the organization is not aware of a consumer push for more mutual fund outlets -- whether operated by banks or other entities. Similarly, we are unaware of consumers knocking on the doors of the Congress in demand for bank operated mutual funds.

Second, we are aware that the banking industry enjoyed record setting profits last year, as in the previous year, and there seems to be no emergency need to open new lines of business to protect the earnings of the industry.

Third, we are aware -- through both government and private surveys -- that there is widespread confusion among the public about the nature of risk associated with investment products, including mutual funds, sold by banks and bank subsidiaries.

Finally, the Congress, through bills introduced by Chairman Dingell and Chairman Gonzalez, are attempting to establish specific

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[2] **Securities Marketing News**, February 25, 1994, p.2.

statutory guidelines to end the confusion among the banks and the regulators -- and most importantly among the public.

A TARNISHED FDIC SHIELD

Last year, the banking industry, with the shield of the Federal Deposit Insurance Corporation (FDIC) displayed prominently in every bank, peddled $92 billion of mutual funds to an unwary public.

The banks' sales practices, we believe, are all too often designed to lead the unsuspecting customer into believing that good-ole Uncle Sam and the taxpayers are guaranteeing the investments. The funds -- like all investments in the stock market -- carry risk and none of that risk is insured or protected in any manner by the Federal government.

In short, Mr. Chairman, the protective shield of the Federal Deposit Insurance Corporation (FDIC) -- symbol of security for millions of American consumers -- is being tarnished by bankers hell-bent on becoming big-time players in Wall Street's mutual funds and annuities market.

The banking industry, as well as the Congress and the American public, should want that shield protected. Certainly, the full faith and credit of the United States taxpayers -- symbolized by that FDIC logo -- should not be utilized by the banks as a means -- directly or indirectly -- of duping customers into believing that investments in the stock market are risk-free. There should be no question about what that shield protects and what it does not protect.

CONSUMER CONFUSION REIGNS

Little wonder, then, that unsuspecting customers -- lulled into a false sense of security by decades of fail-safe insurance for their deposits -- walk out of banks thinking their investments are risk-free.

In January, a survey released by the American Association of Retired Persons (AARP) and the North American Securities Administrators Association (NASAA)[3] revealed that 82% of American consumers are unaware that mutual funds sold through banks are not insured by the FDIC. Ironically, the AARP survey found that consumers who have actually purchased mutual funds at their bank are even less well informed about the risks associated with such investments than are other bank customers.

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[3] **Bank Investment Products Survey: January 1994.**

Last November, the Securities and Exchange Commission released survey data that found similar levels of confusion among bank customers concerning the uninsured status of mutual funds sold by banks.

The fact is that consumers are not well informed about the risk of investment products peddled by banks. We need not conduct further studies to determine that there is a serious problem in the lobbies of insured financial institutions.

Bank marketing efforts are clearly adding fuel to the firestorm of confusion. A recent report of the New York City Department of Consumer Affairs[4] revealed that only 40% of surveyed banks stated that mutual funds were not FDIC insured. The report also observed far more aggressive sales tactics by banks compared to that of mutual fund companies:

> "Generally, the bank representatives gave a much harder sell than the fund company representatives, perhaps because the bank agents earn commissions, while the fund-company agents generally do not. For example, agents from both Citibank and Chase were hesitant to give information over the phone or through the mail, but particularly eager to have the undercover Consumer Affairs investigator who phoned come into the office for a face-to-face sales presentation. Without understanding much about mutual funds, face-to-face sales presentations can be intimidating to new investors.
>
> Furthermore, bank customers who become first time mutual-fund buyers are generally more cautious and conservative than those more familiar with the territory. But few bank employees selling mutual funds pushed conservative investments....[A]ll of the five bank representatives pushed the higher-yielding, and more risky growth funds rather than the more conservative bond funds."[5]

Most recently, Consumers Union reports in the March 1994 edition of <u>Consumer Reports</u> that consumers can expect that "the odds of getting good advice at a bank that sells mutual funds are worse than 1 in 6".[6]

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[4] **Making Sense of Mutual Funds: Tricks of the Trade and Lessons for Investors: August 1993.**

[5] **Making Sense of Mutual Funds: Tricks of the Trade and Lessons for Investors,** pgs. 29-30.

[6] **Should You Buy Mutual Funds From Your Bank?: Consumer Reports, March 1994, p. 148.**

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REGULATORS RESPONSE

The response by the bank regulatory agencies to the rising tide of securities activity by depository institutions has been a classic example of those agencies age-old approach -- "banks first and consumers last".

In essence, the regulators have suggested that consumer safeguards are just fine so long as the protections don't interfere with the banks' headlong rush for profits.

Last month the Washington Post, quoting data collected by the American Bankers Association, noted that the four agencies had produced four different answers about the seriousness of the confusion created by mutual funds bearing the identical or similar name of an insured bank.

Two weeks ago the agencies -- faced with mounting publicity and with the prospect of action by this Committee and the Banking Committee -- finally decided that they were all part of the same government and came up with an "Interagency Statement" on retail sales of non-deposit investment products.

What has emerged in this "policy" statement is a set of lowest common denominators with "should" -- not "shall" -- the dominant verb.

I quote the regulators:

> "Moreover, sales activities involving these investment products <u>should</u> be designed to minimize the possibility of customer confusion and <u>to safeguard the institution from liability</u>..."

In a number of critical areas the "Interagency Statement" does not correct egregious practices. Rather, it institutionalizes them.

For example, on page 8 of the statement, the regulators endorse the use of promotional brochures and advertising where both uninsured and insured products are advertised together.

The agencies only suggest that the material "clearly segregate" the information. What does this mean? Two space between the two distinctly different products or on separate pages of the same brochure?

This is reckless guidance. The two products -- insured and uninsured -- should not appear in the same advertisement or in the same promotional brochure. No segregation within the same document or the same advertisement on television on in newspapers will do the job -- it only ensures more confusion for the investing public.

And when it comes to the big problem of "name" -- the use of an insured bank's logo or name -- the agencies again take the easy way out. A "similar" name should be used, the regulators say, in a sales program "designed to minimize the risk of customer confusion". In short, bankers can be creative in duping customers -- be a little subtle in sliding that FDIC logo in front of the mutual fund customer.

The separation has to be total -- no similarities -- or the regulation is a further fraud on the public.

On the critiacl matter of the separation of personnel, the agencies provide a road map for the banks to make full utilization of personnel across the lines of insured and uninsured products.

The interagency statement allows personnel which handle insured deposits to "recommend" investment products so long as they have "reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer."

Translation: you don't need separate personnel -- and if this confuses the public about government insurance, too bad.

And if this is not enough, the tellers are to be allowed "nominal fees" to encourage the referral of customers for non-deposit investment products.

So what happens to an elderly consumer when she walks in to the bank seeking a safe place for the $50,000 she has just earned in the sale of her house? Does the teller -- with the thoughts of a referral fee at hand -- urge her to forego government insurance and, instead, invest in some of those nice securities being sold at the desk across the lobby?

And if this happens, how do the examiners and the supervisors really detect the game? The answer, we believe, is that in most cases they won't.

In short, the regulators have failed to face up to the realities of the problem. While the banks have roared forward and while the consumer has been left in a sea of confusion about government insurance, the regulators continue to encourage questionable practices by the banking industry -- dangerous practices that put hard-earned savings of consumers at risk -- when the consumers had no intention of placing their funds at risk.

Caught playing fast and loose with the Government's insurance the banking industry is rushing its lobbyists to Capitol Hill and to the media in an attempt to convince everyone that the answer is "self-regulation".

Clearly, the Congress is the last best hope for the consumers of banks are to be prevented from using the FDIC insurance and logo as a tool to fool consumers.

CONGRESSIONAL ACTION NEEDED

Congress created the deposit insurance system and has an obligation to enact safeguards that protect not only the customer, but the integrity of the FDIC shield.

Thanks to Congress' support of Federal deposit insurance, consumers don't think twice about the safety of savings once placed in the hands of a banker.

It is the Congress that must take responsibility and enact legislation that will ensure that there can be no commingling -- in practice or perception -- of insured and uninsured activities of banks.

The hard simple fact is that too many American consumers do not understand that investment products -- like mutual funds and annuities -- sold by banks are not guaranteed by the Federal government.

We believe that the Congress must act swiftly and not wait for the rude awakening of a stock market "correction" to enact safeguards to protect consumers against misleading marketing efforts by FDIC-insured institutions.

Consumers need four key protections:

(1) an insured institutions's name and logo must be separate from the label of an uninsured product;

(2) the location of insured activity within a bank must be clearly separated from the location of the marketing of uninsured products;

(3) bank employees who handle insured funds must be separate and distinct from those that peddle uninsured products; and,

(4) consistent functional regulation of the securities activities of insured institutions.

Before banks expand further into the mutual fund market in any manner -- including the pending application by Mellon Bank Corporation to acquire the Dreyfus Corporation -- protections must be in place that will make certain that there is no misunderstanding in the public's mind about banks being some kind of "risk-free" zone for mutual funds.

Until proven protections are in place, we believe that it would be reckless to add to the problem by allowing banks to expand further into the securities business. There is a serious problem in the market. It is a modest demand that the industry and their regulators should get it right before letting banks further expand into the securities business.

Mr. Chairman, we believe a full moratorium should be placed on expansion of bank operations in the mutual fund business until:

(1) the Congress has a chance to enact statutory safeguards;

(2) the regulators come up with consistent, coordinated and proven approaches to the problem; and,

(3) the banking industry, itself, gets its act together and agrees to eliminate practices -- however subtle or overt -- that permit visions of government insurance standing behind mutual funds to dance in the public's mind.

CONCLUSION

The mixture of commercial banking and investment banking raises a multitude of questions about conflicts of interest, safety and soundness and consumer protection.

While Congress continues to debate how far banks should reach into the securities business, it has an obligation to provide consumer protections up front -- safeguards that will prevent FDIC logos and insurance from being transformed from symbols of personal and financial safety into deceptive marketing tools for bank-sold mutual funds.

Mr. DINGELL. Thank you very much, Mr. Lewis.

The gentleman from Colorado.

Mr. SCHAEFER. Thank you, Mr. Chairman. I thank the panel for being here, and Ms. Archuleta for coming such a long way.

I have a couple of questions, Ms. Colasanto, on number 21, page 38 of your survey, and I want to make sure I read this right, 88 percent of the people have trust in their own bank. Am I reading that right? This is what they said?

Ms. COLASANTO. That's correct.

Mr. SCHAEFER. In other words, whatever the bank says?

Ms. COLASANTO. Eighty-eight percent of bank customers said that they don't think they were ever misled or misinformed about the risks involved with bank accounts or investments at their bank.

Mr. SCHAEFER. So this looks like this is precisely the reason, or at least a lot of the reason, why we had the Lincoln Continental thing, simply because they trusted the bank.

Ms. COLASANTO. The customers were very trusting. That's right.

Mr. SCHAEFER. I would like to ask any of you, Mr. Simon in previous testimony said a number of things regarding how he thought we could improve on the situation. Ms. Crawford, you didn't mention one that he did and I wanted to ask you about it. That's a cooling off period. In other words, if a consumer went in, purchased mutual funds or whatever, and then turned around and decided later that they didn't want them, do you think that's a good idea?

Ms. CRAWFORD. I certainly would never object to a cooling off period in the context of helping consumers. Certainly that seems like a good idea.

One of the things that disturbs me is the idea that even with a cooling off period, by virtue of the fact that there are special circumstances that exist when sales are made on the premises of banks, it still may not be enough.

Mr. SCHAEFER. I'm not saying this is the only thing we do. I mean, this would just be an additional safeguard to be considered.

Ms. CRAWFORD. Certainly, in addition to the suggestions that others have made here today, along with ourselves, we would think that that would go a long way toward helping consumers.

Mr. SCHAEFER. Anyone else, please?

Mr. LEWIS. Congressman Schaefer, we would certainly endorse a cooling off period.

Mr. SCHAEFER. Seven days, 10 days, something like that?

Mr. LEWIS. The exact time period, I think we have not given a great deal of thought to, but we have the similar protections on the credit side, the Truth in Lending Act that permits consumers to have a right of recision. And we think it is very important for the consumer to be able to go home and contemplate an investment in an uninsured product without the bias of the heavy sales pitch of a bank salesperson who is operating with the incentive of commissions right in their face. And a cooling off period would be, as you point out, one element that would begin to make some more sense and ensure that consumers are making informed decisions.

Mr. SCHAEFER. Ms. Archuleta?

Ms. ARCHULETA. I think it sounds like a good idea. We have this privilege with hearing aids and they don't cost quite that much as you might be investing.

Mr. SCHAEFER. Very good correlation there.

Some of these questions, anyone please.

I understand that some of the organizations you represent have gathered samples of literature that banks are using to promote the sale of securities. Tell us what some of the problems are that you may have unraveled with this.

Ms. CRAWFORD. One of the major ones that we found in our collection of brochures and whatnot is this terrible confusion that exists with regard to there being no distinction between the insured and uninsured products. And oftentimes, banks will be selling through registered broker-dealers. But from the investor's standpoint, they may not know that. They cannot tell the difference between the bank and the registered entity because the names may be so similar.

There are just a myriad of problems that we do not know about because there have not been the kinds of customer complaints to date that we anticipate receiving down the road.

As has been noted previously, oftentimes investors have no idea who to complain to.

Mr. SCHAEFER. I understand. But you say as you will be seeing or you may be seeing down the road. Is that why—you have not received the complaints now, why would you see more down the road?

Ms. CRAWFORD. Well, we are hopeful that the publicity and media attention surrounding these hearings will cause consumers to become aware perhaps for the first time that there are regulators out there that would be interested in hearing from them.

Right now, we have reason to believe that if there is a problem, they either do not complain to anyone or perhaps at most complain to the financial institutions.

Mr. SCHAEFER. To the bank itself.

Ms. CRAWFORD. Right.

Mr. SCHAEFER. Ms. Archuleta?

Ms. ARCHULETA. I have an example picked up here in Washington just in the last few days. And this institution lists its investment options, which are about 12 of them here not insured by FDIC. There is a small number 1 listed after the first one and I look to the bottom. Number 1, there is nothing here, and I finally found it on the back in print half the size which talks about the disclosure that they are not FDIC insured.

Mr. SCHAEFER. So there is nothing on the front?

Ms. ARCHULETA. No. And actually each of these investment options should have been starred, it seemed to me, instead of the one small 1. An asterisk would have called my attention to it. And the disclosure should have been—the corresponding statement should have been at the bottom of the page and not at the very end of the brochure.

That is the kind of thing we are talking about that is elusive to older people who may not see that well. I can hardly read this myself.

Mr. SCHAEFER. Mr. Lewis?

Mr. LEWIS. Congressman Schaefer, in addition to the issues of disclosure, hidden disclosure, I did not bring but I would like to submit for the record, if that is possible, examples of institutions

that use the same corporate logo across the insured institution or its sub. You will have the same logo for promotion of an uninsured mutual fund, stock opportunity, or an annuity investment opportunity. And, here again, the institution is playing on the good will and the sense of security that has been built up associated with the insured institution's logo.

Mr. DINGELL. Without objection, the record will remain open for you to make that insertion.

[The following letter was received:]

CFA
Consumer Federation of America

RECEIVED
94 APR 12 PM 3:44
ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

March 25, 1994

The Honorable John Dingell
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
United States House of Representatives
Washington, DC 20515

The Honorable Dan Schaefer
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
United States House of Representatives
Washington, DC 20515

RECEIVED
94 APR 12 PM 3:44
ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

Dear Chairman Dingell and Congressman Schaefer:

At the March 2, 1994 Subcommittee hearing on the Mellon Bank Corporation and Dreyfus Corporation merger I discussed concerns that the Consumer Federation of America (CFA) has regarding the use by insured depositories of their corporate name and/or logo in the marketing of uninsured investment instruments like mutual funds.

At that time, I promised to forward to the Subcommittee an example of such promotional materials. Please find these attached.

These promotional materials were obtained from the Connecticut Avenue and K Street branch of Crestar National Bank in Washington, DC on February 1, 1994. The varied product brochures -- promoting insured savings instruments, uninsured investment instruments (both mutual funds and insurance annuities) and brokerage services of the institution -- were available to the public on the same branch lobby rack.

As is evident, the promotional material for both insured and uninsured instruments utilizes the <u>identical corporate logo</u> of the insured institution.

We believe that this type of retail promotional material blurs the distinction between the insured and uninsured status of savings and investment instruments marketed to retail bank customers. Promotional material that commingles the insured and uninsured status of financial instruments exacerbates consumer confusion about the risk associated with bank marketed instruments.

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

Because the use of a common corporate name and/or corporate logo on insured and uninsured products fails to distinguish between instruments with Federal Deposit Insurance Corporation (FDIC) coverage and those without, the CFA advocates that the use of identical, common or similar names and logos should be banned in the sale of uninsured instruments by, or on the premises of, insured institutions.

We believe that prohibiting the use of identical, common or similar names and logos would begin to clear the financial services market place of consumer confusion and uncertainty concerning insured status of retail financial instruments, assist consumers in the making of informed investment decisions and preserve the integrity of the FDIC insurance program.

Should the Subcommittee require any additional assistance in its investigation into bank sale of securities products and the merger of Mellon Bank Corporation and the Dreyfus Corporation, please do not hesitate to contact us.

Sincerely,

Chris Lewis

Chris Lewis
Director of Banking and Housing Policy

Is Use of a Common Name or Logo on Insured and Uninsured Products Confusing?

Now you can invest in a mutual fund without giving your money to strangers.

CrestFunds* now available at Crestar.

No matter how much or how little you know about mutual funds, it's reassuring to know you can now invest in mutual funds through the very same company you've known for years. Crestar.

The registered investment representatives you'll be dealing with at Crestar are experienced professionals. They'll listen to your needs and long-term plans. They'll get to know you, understand your financial goals and your willingness to take risks. Then, choosing from a variety of CrestFunds available, they'll help you put together a mutual fund investment program that helps meet your investment objectives.

So, why wait to start investing? Come to any nearby Crestar office today, where you'll be well taken care of and completely at ease.

CRESTAR

Crestar Securities Corporation

CrestFunds are sold through Crestar Securities Corporation, a wholly owned securities brokerage subsidiary of Crestar Financial Corporation. CrestFunds are distributed by Fidelity Distributors Corporation, which is not an affiliate of Crestar Financial Corporation. CrestFunds are not insured by the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board or any other governmental agency and are not bank deposits or obligations or guaranteed by any financial institution. Crestar Bank serves as transfer agent and custodian for CrestFunds, Inc. and the Bank's wholly owned investment advisory subsidiary, Capitoline Investment Services Incorporated, serves as investment advisor to CrestFunds, Inc., for which they are compensated. For more complete information about CrestFunds, including charges and expenses, call 1-800-451-5435 or contact your Crestar Investment Representative for a free prospectus. Be sure to read the prospectus carefully before investing.

Mr. SCHAEFER. Did any of you use testers? You have heard about testers. You heard about them in the previous witness' testimony. Did anybody use testers just to go in and see what somebody would say?

Ms. CRAWFORD. Mr. Schaefer, we did, although we did not call them testers. We called them examiners.

Mr. SCHAEFER. Called them what?

Ms. CRAWFORD. Examiners. The Texas Securities Board in an effort to find out whether, first of all, problems existed in the State of Texas sent out several of its investigators to take a look at what is going on in their local banks and in banks State-wide.

We sent them out with a series of instructions on things such as look for signage, look for physical proximity with teller operations, take copies of the brochures, sit down and present yourself as a typical person who perhaps has a CD that is about to become due and wishes to make an investment, and see what the people tell you at the bank.

In my written remarks, you may notice that we gathered statistics with regard to what these individuals were told and what the signage situation was like, and it was very interesting. It paralleled very closely another survey that was done in New Jersey and a report that Consumer Reports came out with when they sent out testers.

All of this evidences that we have problems, and the problems are not just regional; they are nationwide. I do not want to leave you with the impression that the problems might be confined to Texas or any one particular State. I think that all of these surveys that were conducted by testers or examiners or whatever have shown us the problems exist.

Mr. SCHAEFER. Mr. Lewis, have you ever had any experience with that?

Mr. LEWIS. We have not as an organization employed the use of testers at this point. I do note in my written statement a report of the New York City Department of Consumer Affairs, which conducted a tester-like study last year. That report—those testers discovered that of the institutions that they went into only 40 percent of those institutions revealed to the Department of Consumer Affairs personnel that a mutual fund investment was not an insured investment opportunity. The statement goes through some other data that was discovered in the course of that testing-like program, but we have not ourselves.

It is something we have contemplated, I think. As the previous panel bore out, though, an effective testing program is something that needs to be very carefully thought through, and is one that institutions seem to evade if they know it is coming around the block.

It is something that we very much feels should be part of an ongoing enforcement effort by appropriate regulatory agencies that have jurisdiction over bank sales of uninsured products. It is a detection as well as a deterrent tool.

Mr. SCHAEFER. Mr. Archuleta, has AARP done anything along these lines?

Ms. ARCHULETA. I am not aware of anything.

Mr. SCHAEFER. OK. One final thing, Mr. Chairman. I know my time is about up here, but on this Mellon-Dreyfus situation, Ms.

Crawford, was there anything in there pertaining to that? Did you look at the Mellon Bank at all? Was that one that you tested?

Ms. CRAWFORD. No, sir. We did not test that bank.

Mr. SCHAEFER. Mr. Chairman, thank you very much. I yield back.

Mr. DINGELL. The Chair thanks the gentleman.

Members of the panel, the committee is very grateful to you for your presence here. I have a few questions that I would like to direct at you at this particular time.

Perhaps I could direct all of these questions to all members of the panel so that you each have the opportunity to address then in such order as you might choose.

You have talked about the research studies, or sending testers into banks, or taking polls. Starting with you, Ms. Crawford, what are your feelings about the situation that you are finding, and what do you feel the implications of it might be?

Ms. CRAWFORD. Well, as you might expect my answer is that in my view the situation is very bad. It is a frightening situation, and I think it has very far-reaching implications.

The thought that we have many, many millions of Americans who are dissatisfied with the interest rate that they are receiving on their insured investments are now switching over to uninsured investments on the premises of banks, where perhaps they have been doing business for many decades or their entire lives, where they are not asked any questions that lead to a determination of whether switching to an uninsured product would be suitable for them, where they may have no reason on earth to believe that what they are going to switch into does not have the full faith and credit of the United States behind it. It is just frightening.

We have heard from the Lincoln Savings prosecutorial group, and I think that many of the things they had to say were analogous to things that people could be saying to this committee several years hence if something is not done.

Mr. SCHAEFER. Thank you. Ms. Archuleta?

Ms. ARCHULETA. I think I just wanted to add that I live in a high-rise of senior citizens of about 100 people. It is always amazing to me that they continue to go to the bank that is clear across town because they know the people and they trust them. So I think we need to do many of the things that we have talked about this morning in order to protect those people.

Sometimes when I discuss this issue with my neighbors and I talk about uninsured and insured products, and they will say, "Well, I wonder if my mutual funds are insured?" And I say, well, no they are not, and they say, "Oh," but they do not say anything more.

Many people are unwilling to tell you that they have lost money because maybe they think $2,000 was really not too much, but it was really quite a bit in their terms.

Mr. SCHAEFER. Ms. Colasanto, would you like to tell us whatever you might have in mind on that?

Ms. COLASANTO. Sure. I think the survey evidence is very clear that bank customers are confused. They simply are not aware or have the wrong impression about whether their investments that they purchase at banks are FDIC insured.

I think one other thing that came out in our study that I want to note is who is buying these products. It is people at the lower end of the income scale who are purchasing these products as well as people who have a little bit more of an income cushion, so the implications for the individuals who are taking on this risk could be great.

Mr. SCHAEFER. Thank you. Mr. Lewis?

Mr. LEWIS. Obviously, we believe that there is a very serious problem here. We have got millions of consumers out there who are willingly and unwillingly placing their savings at risk. We are not talking about spare change here.

It is probably on the order of $2 billion a week in consumer savings that are being put into uninsured investment instruments on or through bank sales programs, and that number is probably going up as each week progresses. So we have a very serious concern about whether or not the channeling of these savings is being done in an informed manner.

As I noted in my oral statement, this certainly brushes against whether or not we are, as a Nation, retaining the integrity of the FDIC program; at what cost this activity and the level of confusion and the level of confusion has for the integrity of the FDIC program.

Finally, we are very much concerned about the lack of consumer protection programs at the banking regulatory agencies. This has not been their traditional focus. In fact, historically they have been very poor performers in consumer protection, and have no track record really in investor protection.

I noted some of the very serious problems we have with their current guidelines, which are only guidelines; these are not mandates. There are, as evidence presented here, very serious compliance problems with those guidelines, much less their basic inadequacies, but I think we are very concerned about consumers making uninformed decisions and the lack of an effective consumer compliance and enforcement program amongst banking regulatory agencies.

Mr. DINGELL. Can you give me your thoughts now, please, members of the panel. What are your thoughts regarding security salespersons at banks in gaining access to individual bank records and customer lists. Do you have a feeling on that, Ms. Crawford? You are regulatory, and you understand these matters very well. What are your thoughts?

Ms. CRAWFORD. Well, it seems entirely inappropriate. I certainly think that if the vast majority of Americans were aware that that could occur, they would be up in arms and would probably be storming your office.

I think there is a level of innocence, if you will, about that kind of activity. It is something that makes it very difficult for securities regulators to deal with, though, because, as Chairman Levitt pointed out this morning, securities regulators for the most part can only go so far. They can only get certain records.

If the bank itself is engaging in the activities, there is nothing under the securities law that allows the securities regulator to obtain that sort of information and see if it is being misused.

Mr. DINGELL. Would it be fair to say that it is a situation rich in opportunity for wrongdoing, pressure and impropriety?

Ms. CRAWFORD. Absolutely.

Mr. DINGELL. Ms. Archuleta, do you have a comment?

Ms. ARCHULETA. No.

Mr. DINGELL. How about it, Mr. Lewis?

Mr. LEWIS. The sharing of private, personal, financial information with the consumer being unaware that that information is being slid to another corporate entity is very troublesome to us, particularly, obviously, in the area of the roll-over of CD's of large savings.

I know that this is one matter that is addressed in pending legislation across the hall in the banking committee. I do not know why we need to await legislation here. The regulators ought to just outright ban the sharing of private—of financial information.

I very much agree with the comments of Ms. Crawford that if the consumers we talked to were aware that this information was being shared, they would be outraged.

Mr. DINGELL. Now, Ms. Crawford, OCC and Mellon are promising aggressive campaigns relating to visual devices to be used to sell securities such as logos, prospectus, and signed statements in order to dispel the notion that mutual funds are insured. However, we heard from the previous panel that the single most important aspect was conversations between the salespeople and the buyers.

Do you agree with that, and do you believe that it is necessary for Mellon, OCC, and FDIC to use testers to assess what is actually going on and what is being said to potential buyers to ensure the protection of customers of the banks against undue pressure, deceitful and improper practices?

Ms. CRAWFORD. Mr. Chairman, you have asked two questions. In answer to the first, absolutely, I agree with that statement.

As to the second, I do not see how any regulator can tell what is going on if they do not send somebody into the institution to test. Whether you call it an examination or testing or whatever, it is absolutely essential that that be done.

I might add that it would be more useful to actually have people that have a preexisting relationship with the institution serve as testers because, as was pointed out to us at NASAA in the Keating situation, it appeared that there was a difference in approach taken with regard to individuals who had a preexisting relationship with the financial institution as opposed to those people who did not have such a relationship.

In the latter circumstance, they were treated much more with kid gloves. All the "i's" were dotted; all the "t's" were crossed, which was not the case when a person who had the preexisting relationship came into the financial institution.

You can see why that would be the case if you are selling a product based upon the trust that you have enjoyed with this individual through the years. If you were preying upon that then there is no need to dot the "i's" and cross the "t's" if you are not of a bent to do so.

Mr. DINGELL. Ms. Archuleta and Mr.Lewis, do you have feelings on that matter?

Ms. ARCHULETA. No, sir.

Mr. DINGELL. Mr. Lewis?

Mr. LEWIS. We very much think that testers should be part of an ongoing enforcement regime. We do not have much confidence in self-testing by institutions themselves.

I think it is important to note that testing is a detection effort to determine whether or not agreed upon sales practice and conduct practices are being adhered to or not. We believe that we need to remove as many of the incentives that currently exists to misinform consumers about the nature of insured—of the uninsured status of securities products from the marketplace.

That is why we are very much opposed to the payment of referral fees to tellers and to other personnel of the insured institution, and there should be no commingling of personnel between the insured institution and the uninsured sub or contracted brokerage firm, obviously.

Second, we believe that there ought to be some consideration for a prohibition on any commission compensation that does provide an incentive for a bank employee or a hired hand to gloss over in their communication with the consumer the full nature of a marketed investment instrument, and that perhaps we ought to, for purposes of sale of these instruments in banks, they ought to only be done by salaried personnel, not those that are subject to the colluding influence of commissions.

Mr. DINGELL. Do you agree with that, Ms. Crawford?

Ms. CRAWFORD. Yes, sir. I do.

Mr. DINGELL. Now, we find ourselves here with the situation at hand. Just yes or no. Do each of you believe that regulators such as the OCC and FDIC are aggressively protecting consumers in these matters?

Ms. CRAWFORD. No.

Mr. DINGELL. Ms. Archuleta?

Ms. ARCHULETA. No, I do not.

Mr. DINGELL. Mr. Lewis.

Mr. LEWIS. No.

Mr. DINGELL. Should we encourage the further expansion of banks into the mutual fund business under the current regulatory scheme and regime?

Ms. CRAWFORD. No.

Mr. DINGELL. Ms. Archuleta?

Ms. ARCHULETA. No, Mr. Chairman.

Mr. LEWIS. We have a forest fire out there, and I do not know why we would need one; why we would ever want to put more fuel on it. We've got to put this out. We have to first find the tools that we need to put onto it that will distinguish the firestorm of confusion and deception that is at play. Obviously, we do not think we should add to the problem.

Ms. CRAWFORD. Mr. Chairman, I would like to add if I may that it is important to note that we are talking about shares of mutual funds today, but there is absolutely nothing that would stop these financial institutions from selling interests in limited partnerships or perhaps the more arcane derivative products in the future, which cause many more problems than what we have discussed here this morning and early this afternoon.

Mr. DINGELL. I think you have raised an excellent point to which the committee had not really fully addressed itself, but you are talking about derivatives, you are talking about a potential for futures, you are talking about mutual funds, you are talking about over-the-counter sales of stocks of different kinds, perhaps, penny stocks, perhaps stocks that are regulated by the SEC or stocks that are simply regulated by the States. You are talking about the penny stocks, which everybody knows are poorly regulated, which could be sold under similar circumstances.

Now, would you favor any of those activities being expanded within the borders of the banks?

Ms. CRAWFORD. No, sir. I would not.

Mr. DINGELL. Well, the Chair wants to express the thanks to the committee and also my personal thanks. The Chair notes with some regret that those two lights and those bells that you have been hearing tells us we have votes on the floor, and my watch says I have a minute and 15 seconds to get over there.

The committee stands adjourned with our thanks to you all.

[Whereupon, at 2:20 p.m., the subcommittee hearing was adjourned, to reconvene March 3, 1994.]

PROPOSED MELLON-DREYFUS MERGER

THURSDAY, MARCH 3, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell (chairman) presiding.

Mr. DINGELL. The subcommittee will come to order.

Before we begin, the Chair has a couple of administrative matters to address.

First, the subcommittee has sent a number of investigative letters to the parties to the proposed transaction and to the Federal banking and securities regulators. Without objection, these letters and the responses thereto, together with the exhibits and the briefing memorandum for these hearings, will be included in the hearing record as an appendix. [See p. 400.]

Also without objection, the Chair would like to insert in the record following the testimony of the second panel yesterday an explanation to clarify the sale of Lincoln bonds through the issuer exemption from broker-dealer registration. There was some confusion on this, and the Chair thinks that the record should be clear as to what happened and what the circumstances were.

So, without objection, those two matters will be attended to.

This morning the subcommittee continues its review of the public policy implications of the proposed acquisition of the Dreyfus Corporation by the Mellon Bank. This subcommittee and the full committee have had long standing concerns about the overlap of securities activities and banking activities. These concerns are heightened by a transaction that if approved will create the largest bank mutual fund operation in the country.

The subcommittee heard yesterday that consumers are vastly confused about whether securities products purchased through banks are federally insured. We have also heard that bank marketing practices, as well as factors inherent in any bank sales of securities products, contribute to this confusion. Problematic practices have included the following:

One, use of bank facilities to market securities. Two, hiring of bank personnel, including inexperienced personnel, to market securities. Three, cross-selling by bank employees. Four, using the bank's customer base. Five, inadequate disclosure of risk. And six, contradictory messages about the uninsured nature of the securities.

The subcommittee has heard that the core of the problem was the association between the bank—with its Federal insurance—and the security. Even more worrisome, we heard that confusion reigns despite written disclosures and oral statements.

We also heard yesterday about how unscrupulous marketers targeted—and I am now quoting from some of their instructions to their employees—"the weak, meek, and ignorant" and about the terrible human costs of this confusion. Yet we also were told that the present regulatory system has not offered, nor indeed can it offer, needed protection to investors. Investors in bank mutual funds also find themselves unwittingly in a statutory limbo without the most basic safeguards.

Today we will have before us Eugene Ludwig, the Comptroller of the Currency who, under present law, is all that stands between the fox and the henhouse. In fact, he may eventually serve as doorman to the henhouse. He stands without some of the most basic weapons that have evolved to protect securities investors—express suitability requirements, express training and qualification standards for brokers, private rights of action, securities arbitration, rescission rights, and others. He stands without a mandate to protect the securities investor. His mandate is simply to protect the safety and the soundness of the bank.

Mr. Ludwig recognizes that banks have an obligation to their customers to have them understand that mutual funds are not federally insured. He also acknowledges that bank regulators must address the risks associated with mutual fund activities. He also notes that conflicts of interests can result from mutual fund activities and that these conflicts can be substantial. He will also testify today about some of the actions that he has taken to address these concerns, as well as some of the procedural reforms now underway.

But are the paper protections for consumers being put in place going to be enough? Are the compliance policies and procedures recommended by the recent joint interagency statement on retail sales of non-insured investment products enough? We heard yesterday that they are not. We will ask Mr. Ludwig. Is it appropriate to continue to allow banks to engage in these kinds of activities during a period of great customer confusion? We heard requests yesterday for a pause in new approvals while consumer protections are put in place. We will ask Mr. Ludwig about this.

Do the bank regulators have sufficient statutory authority to protect investors? We heard yesterday they do not. We will again ask the Comptroller: Should we have confidence that the bank regulators will protect investor interests even to the detriment of the bank, or will they protect them at all if the bank's stability and economic well-being are at stake. We heard little yesterday to give us that confidence. We will again ask the Comptroller.

Also testifying today are the top officials from Mellon Bank and the Dreyfus Corporation whose proposed transaction has been the focus of much concern. They have recognized many of the dangers to consumers inherent in this acquisition and will offer a voluntary agreement to address many of them. We commend them for this. But billions of dollars are flowing into mutual funds every week. With that kind of profit at stake, and the potential peril to those investors who don't understand what is at risk, the question is:

Can we rely on volunteerism? On the basis of the record today, I am not sure we can.

As we heard yesterday there are inherent problems that need to be addressed. Consumer confusion is common place despite similar types of protections. The subcommittee will ask these four officers how they plan to address these problems and what level of consumer confusion is acceptable to them as their transaction goes forward.

The Chair wants to express the appreciation to all the witnesses for appearing here today. We look forward to hearing their testimony.

The Chair recognizes my good friend from Colorado.

Mr. SCHAEFER. Thank you, Mr. Chairman.

You have basically said it all. This is the second day of hearing on this very important subject designed to make sure that the consumers in this country are protected. I just look forward to hearing the testimony of the various witnesses we have before us today.

I thank the Chair for allowing Mr. McMillan here today. I think he has an opening statement if the chairman will allow him to do it.

Thank you.

Mr. DINGELL. The Chair thanks the gentleman.

The Chair advises Mr. Ludwig that we do welcome you to the subcommittee. Mr. Ludwig, we are happy that you are with us.

We recognize first the Honorable Eugene A. Ludwig, Comptroller of the Currency. Mr. Ludwig, this is the first time you have appeared before this subcommittee. I know that you understand that it is the practice that all witnesses who appear here testify under oath.

Do you have any objection to so doing?

Mr. LUDWIG. Not at all.

Mr. DINGELL. The Chair advises that since you are testifying under oath that it is your right to be advised by counsel during your appearance here. Do you so desire?

Mr. LUDWIG. I do not.

Mr. DINGELL. Very well. The Chair advises you that copies of the rules of the subcommittee, rules of the House, rules of the full committee are there at the table before you, to inform you both of your rights and limits on the powers of the subcommittee as we go into the proceeding in which we are about to start.

Ms. Broadman, are you to testify, too?

Ms. BROADMAN. No, I am not here to testify.

Mr. DINGELL. We will not swear you. If you choose to testify or you are going to testify, we will have to have your testimony under oath.

Ms. BROADMAN. I would be happy to be sworn in.

Mr. DINGELL. Then maybe we just better do it that way.

Very well, if you have no objection then, please rise and raise your right hand.

[Witnesses sworn.]

Mr. DINGELL. You may each consider yourself under oath. If you will proceed with your written statement, the Chair will recognize you for that purpose.

TESTIMONY OF HON. EUGENE A. LUDWIG, COMPTROLLER OF THE CURRENCY, ACCOMPANIED BY ELLEN BROADMAN, DIRECTOR FOR SECURITIES, INVESTMENTS, AND FIDUCIARY PRACTICES

Mr. LUDWIG. Thank you, Mr. Chairman and members of the subcommittee.

I appreciate this opportunity to testify on the sale of mutual fund investments by banks and specifically on the proposed acquisition of the Dreyfus Corporation by Mellon Bank.

Both the general subject area and the particular application raise important public policy issues. You are to be commended for your efforts to focus public attention on these issues.

I have a detailed written statement that discusses bank sales of mutual funds and the Mellon Dreyfus proposal. In the interest of time, I would like to submit the written statement for the record and focus my discussion this morning on what I have done in the last 11 months to create a regulatory environment for bank mutual fund sales that protects and promotes the interest of the consumer. I will also discuss the broad characteristics of the Mellon-Dreyfus proposal within this context.

Bank trust departments have acted as investment advisers, transfer agents, and custodians for mutual funds for decades. Retail sales of proprietary mutual funds were sanctioned and underway long before I become Comptroller.

In recent years, however, this area of bank activity has seen rapid growth. More than 150 banks—national banks, State member banks, and State nonmember banks now offer their own proprietary mutual funds.

The net assets of proprietary mutual bank funds doubled between 1989 and 1991, and doubled again between 1991 and 1993, reaching $200 billion in 1993. Bank sales of third-party mutual funds—those managed by firms outside the banking industry, also grew rapidly. These third-party funds account for roughly half of all bank mutual fund sales.

This growth in bank mutual fund activity raises new issues for bank regulation from both the safety and soundness perspective and from the perspective of consumer protection.

Since I took office last April I have worked hard to address those issues through a series of actions. Many of those actions have yet to bear fruit, some are bearing fruit already. In particular, I am working toward accomplishing five objectives.

First, to make sure that banks remain within the law as they offer mutual funds to the public.

Second, to make sure that customers understand that mutual fund shares purchased from banks are not federally insured.

Third, to make sure that banks handle their mutual fund operations in a way that does not threaten the safety of the bank or pose undue risk to the bank insurance fund.

Fourth, to make sure that banks address potential conflicts of interest.

And, fifth, to make sure we, the regulators, have the resources to respond to further sales growth in investment products going forward.

To advance these objectives, we have over the last 10 months taken several specific steps.

Number one, I assigned one of my two senior policy advisers to coordinate OCC efforts in the mutual fund area.

Two, within 3 months of my arrival at the OCC, we published detailed guidelines governing the retail sale of mutual funds and other nondeposit investment products by banks. This guidance emphasized consumer protection, particularly by meaningful disclosure.

Three, we organized a working group of all Federal regulators of banks and thrifts to develop interagency guidelines on bank retail sales of mutual funds, guidelines that the agencies released jointly last month.

Four, I urged industry leaders to find a way for banks and thrifts to police themselves in this area, and have repeatedly addressed industry groups on this topic. Partly as a result of this effort, the bank trade associations for the first time adopted joint retail investment product sales guidelines last month.

Five, we have developed a program of mutual fund examinations and have issued new examination procedures to assure that national banks comply with our guidelines. We have devoted substantial time and effort to developing the mechanism for systematic, systemic supervision and examination aimed specifically at bank mutual fund activities.

Six, we are working with the SEC in a variety of ways, including investigations and enforcement actions, information sharing, and periodic staff meetings on policy issues. Further, we have joined the SEC in a research effort, based on a comprehensive survey of households, to improve our understanding of why some consumers are confused when they purchase mutual fund shares and to learn what kinds of disclosures work best in addressing that confusion. Through the use of focus groups in this first phase of this research, we are already gaining important insights into these issues.

Seven, we have published a brochure entitled "Deposits And Investments: There is a Critical Difference" to alert bank customers to the risks in nondeposit products sold by banks. We are distributing the brochure through the Consumer Information Center. We believe more than a million copies of this brochure have now been printed.

Mr. Chairman, my efforts in this area reflect my personal commitment to keep the OCC at the forefront of bank supervision in general and to protect the consumer in particular.

I also bring those commitments specifically to the Mellon-Dreyfus proposal. Because of the importance I assign to both the supervisory and consumer protection issues attending this application, I have taken the unusual step of soliciting public comment on it, and on a similar proposal by First Union National Bank to acquire Lieber & Company and the Evergreen Asset Management Corporation.

We are currently reviewing the Mellon application. In that review, we are particularly focused on the commitments in the proposal and on the availability of appropriate safeguards to ensure that customers understand which products offered by the combined entity would be federally insured and which would not be federally

insured. We are coordinating our review with the Securities and Exchange Commission, and are specifically interested in the SEC's experience regulating Dreyfus, and in whether the SEC had any particular concerns of which we should be aware as we process Mellon's proposal.

Of course, we also want to safeguard the safety and soundness of the combined entity. We will carefully consider the controls utilized by these two entities, and we will carefully consider the adequacy of capital. I cannot tell you whether we will approve this application, but I can assure you that we will not approve it without addressing the important consumer and safety and soundness issues it raises. Let me emphasize that the issue of adequate consumer protection will be an important part of our consideration.

Mr. Chairman, I have spent the last 11 months working to mobilize the OCC, the Federal bank regulatory establishment, and the banking industry itself to address the supervisory and consumer protection issues raised by the growing volume of bank mutual fund activity. We are making progress, but we still have far to go.

I am fully committed to this effort and I am confident that in cooperation with the SEC, my fellow bank and thrift regulators, and industry and consumer leadership, we will overcome the challenges we face in this area.

Thank you. I welcome your questions.

[Testimony resumes on p. 295.]

[The prepared statement of Mr. Ludwig follows:]

TESTIMONY OF

EUGENE A. LUDWIG

COMPTROLLER OF THE CURRENCY

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to testify on the sale of mutual fund investments by banks and, specifically, on the proposed acquisition of the Dreyfus Corporation by Mellon Bank, N.A., a national bank supervised by the Office of the Comptroller of the Currency (the OCC). Bank sales of mutual funds, and this proposal in particular, raise public policy issues of concern to both the banking industry and the public. I commend you for your efforts to focus attention on these issues.

Last year in a major policy address, I made it clear that any decision I make regarding the activities of banks will turn on whether I have the authority to approve an activity and, where I have that authority, on whether the activity can be conducted in a safe and sound manner by banks and on whether the activity benefits consumers of financial services. I developed those criteria because I recognized that in our dynamic financial services market supervisors must regularly decide what products and services banks may offer.

I believe that bank involvement in mutual funds meets those criteria and consequently represents sound public policy. As I will describe in greater detail, such involvement rests upon clear legal authority and poses safety and soundness issues that are no more complex or demanding than others our examiners face day in and day out. Bank involvement in mutual funds also presents clear consumer benefits. It offers customers greater convenience and greater choice in shopping for mutual fund services, and it permits banks to compete on a equal footing with other providers of financial services, enhancing competition in the market for mutual funds.

Supervisory diligence will be needed if consumers are to take the full measure of these benefits, and the OCC has begun that effort. It has been clear to us for a long time that the safety of deposit insurance is inscribed on the minds of bank customers. Bank involvement in mutual funds sales puts that well-deserved sense of security to a new test, for there is a tendency among customers to believe that mutual fund products are as safe as insured deposits. They are not. Banks must take--and we will make sure they take--every step necessary to educate their customers about the true risks of mutual funds. This exercise in disclosure and public education, will help to ensure that customers are not misled, and that they make intelligent and well-educated decisions when deciding to buy or not to buy bank mutual fund products.

In my first year as Comptroller of the Currency, I have also worked to ensure that national banks conduct their business in a way that makes their products and services available to all people. Mr. Chairman, I believe that there is a link between new products and services and the ability of banks to serve the needs of all citizens. In particular, I am convinced that over the long haul locking banks away from profitable opportunities will reduce both their safety and soundness and the competitive vigor of financial markets.

As you are well aware, retail sales of mutual funds by commercial banks have grown dramatically in recent years. More than 150 banks--including national banks, state members banks, and state non-member banks--now offer their own, "proprietary" mutual funds. The net assets of proprietary bank funds doubled between 1989 and 1991, and doubled again between 1991 and 1993, reaching $200 billion in 1993. Bank sales of "third-party" mutual funds (those

managed by firms outside the banking industry), which still account for roughly half of all bank mutual fund sales, also grew dramatically.

Mutual funds activities are not entirely new to banks or their regulators. Under OCC supervision, bank trust departments have acted as investment advisors, transfer agents, and custodians for mutual funds for more than 20 years. Some banks have also provided their customers with access to third-party mutual funds through their brokerage operations. But the rapid expansion in recent years of bank mutual fund activities brings into closer focus a number of important regulatory policy considerations:

- The Glass-Steagall Act prohibits banks from engaging in certain securities activities. Bank regulators must ensure that banks limit their mutual fund activities to those permitted by law, and that they avoid activities that are prohibited by Glass-Steagall.

- The notion that bank customers are protected from loss by the FDIC is deeply ingrained in the public perception of bank products. Bank regulators must ensure that bank customers understand that mutual fund shares purchased from banks are *not* federally insured.

- The risks inherent in mutual fund activities--particularly for banks entering the business for the first time or expanding the scope of their mutual fund activities--poses supervisory issues for bank regulators. We must ensure that banks structure and manage their mutual fund operations in such a way that they do not present unacceptable liquidity, operational, or legal risk to the bank or undue risk to the Bank Insurance Fund.

- As with any nondeposit investment product, a bank's mutual fund activities can raise potential conflicts of interest with its fiduciary obligations to its customers. Regulators must ensure that banks have adequate controls to identify and manage potential conflicts of interest.

- The growth of nontraditional banking activities, including mutual fund activities, exposes banks to new kinds and combinations of risks. Bank regulators must ensure that they have adequate supervisory policies and procedures in place, and adequate numbers of well-trained examiners to carry them out.

The Challenge to Bank Supervisors

The Senate confirmed me as President Clinton's choice to be Comptroller of the Currency on April 4 of last year. Shortly after my confirmation, I concluded that the dramatic increase in the scale of bank mutual fund operations called for decisive action. Many banks are entering into mutual fund operations for the first time, or increasing the scope of their operations

significantly. Some banks are doing so through large acquisitions that can have important implications for the bank's structure and governance. And banks' mutual fund sales efforts are now reaching a far broader set of customers than has traditionally been served by bank trust departments. These developments naturally raise the level of supervisory concern with how banks conduct their mutual fund operations. Let me list some of the things we've done in the last year.

- I met with consumer groups to gain a better understanding of bank customer concerns.

- I communicated to the banking industry, in several major speeches, the importance of adopting practices that would help ensure that their customers understand the risks of nondeposit products banks sell.

- I assigned a Senior Policy Advisor, David Apgar, formerly of Lehman Brothers, a New York investment bank, to coordinate OCC efforts in the mutual funds area.

- In July, 1993, we published detailed industry guidance on the retail sale of mutual funds and other nondeposit investment products--the first of its kind published by any bank regulatory agency.

- We worked closely with the other Federal regulators of banks and thrifts to develop interagency guidelines, which the agencies released jointly last month.

- I had a number of meetings with industry leaders to impress upon them the importance of taking steps to avoid customer confusion. Partially as a result of those meetings, the banking trade associations adopted retail investment sales guidelines.

- The OCC developed a program of mutual fund examinations, and issued new examination procedures to ensure that national banks comply with our guidelines.

- I had a number of meetings with SEC Chairman Arthur Levitt to discuss the issues surrounding bank sales of mutual funds, and we initiated ongoing staff-to-staff contacts to see how we could coordinate our supervisory efforts.

- OCC and SEC staff have initiated a joint research effort, including a comprehensive survey of households, to improve our understanding of the sources of confusion when individuals purchase mutual fund shares and to learn what kinds of disclosures work best in addressing that confusion.

- Working with the banking industry, the OCC has begun an effort to contact bank customers to learn directly from them about their experiences in purchasing mutual funds from banks.

- We published a brochure entitled *Deposits and Investments: There's A Critical Difference* to alert bank customers to the risks in nondeposit products sold by banks. Nearly one million copies of the brochure have been made available to the public.

Mr. Chairman, our efforts in dealing with bank sales of mutual funds are an important part of my commitment to keep the OCC at the forefront of bank supervision. To meet that commitment, it is critical that we stay abreast of change and develop policies and practices that are appropriate in a dynamically changing market for financial services.

I will now turn to a discussion of the issues facing banks that engage in mutual fund activities and their supervisors.

Legal Authority

Although my tenure as Comptroller began after the significant statutory, judicial, and interpretive developments in this area, I have included this brief history and description of banks' legal authority for the convenience of the Subcommittee.

The authority of national banks to engage in activities related to mutual funds derives from the National Bank Act's grant of authority to engage in activities that are part of or incidental to the business of banking[1], and from national banks' express powers to provide fiduciary and custodial services and to act as transfer agents[2]. Banks and their affiliates or subsidiaries may provide investment advice to mutual funds and to customers, may broker mutual funds, may advertise and market their services, and may provide a range of administrative and shareholder-related services to mutual funds. Such services may include acting as transfer agent, custodian, and registrar, and providing record-keeping, accounting and related services. However, national banks have not been authorized to sponsor or distribute most mutual funds.

[1] 12 U.S.C. § 24(7)

[2] 12 U.S.C. § 92a; 15 U.S.C. § 78q-1

Bank Powers. Section 24(Seventh) grants broad powers for banks to engage in the business of banking, including the specific powers recited in the statute[3] and such other incidental powers as are reasonably necessary to perform the business of banking as a whole. The courts have used various tests to determine whether specific banking activities are within the intended scope of Section 24(Seventh), and have found that permissible incidental activities include those that are similar to an express power, relate to an express power, resemble traditional banking functions, or constitute financial activities.[4]

Banks have authority to buy and sell securities for the accounts of customers as part of the business of banking. This authority under the bank powers clause is evidenced in the history of the years prior to the passage of the Glass-Steagall Act and predecessor provisions of the 1927 McFadden Act[5]. While Section 16 of the Glass Steagall Act placed limitations on certain securities activities of banks, this provision specifically preserved banks' power to broker such securities "solely upon the order, and for the account of, customers, and in no case for its own account."[6] Various court opinions confirm the long-established powers of banks to perform brokerage services.[7] Accordingly, securities brokerage activities are permissible by national bank subsidiaries including the purchase and/or sale, as agent, of shares in mutual funds.[8]

National banks and their subsidiaries have the authority to provide investment advice as part of or incidental to the business of banking.[9] Investment advice is integral to the brokerage

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[3] (1) Discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; (2) receiving deposits; (3) buying and selling exchange, coin, and bullion; (4) loaning money on personal security; and (5) obtaining, issuing, and circulating notes.

[4] See Letter No. 494 (December 20, 1989), supra, at 11-16; see also M & M Leasing Corp. v. Seattle First National Bank, 563 F. 2d 1377 (9th Cir. 1977), cert. denied, 436 U. S. 956 (1978); New York State Ass'n of Life Underwriters v. New York State Banking Dept., 598 N.Y.S. 2d 824 (N.Y. App. Div., 1993). (The court found that similar incidental powers clause of New York banking law permitted banks to expand banking services over time consistent with evolving business practices and customers' needs.)

[5] See 12 U.S.C. § 24(7).

[6] 12 U.S.C. § 24(7).

[7] See e.g., SIA v. Bd. of Governors of the FRS, 468 U. S. 207 (1984) ("Schwab"); SIA v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), aff'd per curiam, 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986) (brokerage issue).

[8] See e.g., Interpretive Letter No. 622 (April 9, 1993); Interpretive Letter No. 403 (December 9, 1987).

[9] See e.g., Interpretive Letter No. 622 (April 9, 1993) and Interpretive Letter No. 367 (August 19, 1986); see also Bd. of Governors of the FRS v. ICI, 450 U.S. 46 (1981); SIA v. Bd. of Governors of the FRS, 821 F.2d 810 (D.C. Cir. 1987), cert. denied, 484 U.S. 1005 (1988) ("NatWest").

and trust powers of banks. Banking entities are permitted to recommend mutual funds to customers and to act as investment advisor to the same mutual funds.[10] In finding that a bank holding company may serve as investment advisor to a mutual fund, the Supreme Court recognized in 1981 that the functions of an investment advisor include management activities.[11]

An integral part of investment advisory and brokerage services is the ability to attract customers by advertising and marketing the services and products available. In 1954, the Supreme Court, in considering a restrictive state law, found that under their incidental powers national banks generally can advertise any service that the bank lawfully offers.[12] In 1986, the District of Columbia Circuit Court recognized, albeit in a different context, that the selling of securities necessarily involves finding and soliciting buyers.[13] The court noted that banks must advertise to let their customers know what services are available. Hence, national banks are permitted to publicize their services relating to mutual funds.[14]

Administrative services related to the provision of investment advice and brokerage services are also incidental to those activities. National banks and their operating subsidiaries are permitted to provide a variety of administrative and shareholder services with respect to the operation of a mutual fund.[15] The Federal Reserve Board recently has approved a nonbanking subsidiary of a bank holding company to provide various administrative and advisory services

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[10] Federal Reserve Board Regulation Y, 12 C.F.R. 225.125; see also Bd. of Governors of the FRS v. ICI, 450 U.S. 46 (1981); SIA v. Bd. of Governors of the FRS, 821 F.2d 810 (D.C. Cir. 1987), cert. denied, 484 U.S. 1005 (1988) ("NatWest"); Interpretive Letter No. 403 (December 9, 1987).

[11] Bd. of Governors of the FRS v. ICI, 450 U.S. 46, 55 (1981); see also OCC Letter from William B. Glidden (January 14, 1988) (national bank investment advisors manage and supervise the investment and reinvestment of cash, securities or other properties comprising the assets of the mutual funds).

[12] See Franklin National Bank v. New York, 347 U.S. 373, 378 (1954).

[13] SIA v. Bd. of Governors of the FRS, 807 F.2d 1052, 1062 (D.C. Cir. 1986), cert. denied, 483 U.S. 1005 (1987) ("Bankers Trust II").

[14] See Interpretive Letter No. 622 (April 9, 1993) (making lobby materials available on services, placing newspaper advertisements, sending statement stuffers and providing other descriptions of the variety of services that are available); Glidden Letter (January 14, 1988) (furnishing prospectus or sales literature on funds upon request, having advertisements and brochures listing mutual funds available through the bank and the bank's services); see also *Interagency Statement on Retail Sales of Nondeposit Investment Products* (acknowledges banks advertise and market uninsured investment products to customers and provides for full disclosure).

[15] See e.g., Glidden Letter (January 14, 1988) (providing various administrative services and acting as investment advisor to mutual funds); Interpretive Letter No. 386 (January 19, 1987) (providing recordkeeping, accounting, and other services in connection with 12b-1 and similar plans); Interpretive Letter No. 332 (March 8, 1985) (recordkeeping, order execution functions, and shareholder information).

to mutual funds.[16] The Board reasoned that such administrative activities generally are ministerial or clerical in nature and do not impart impermissible "control" or policy-making authority over the mutual fund. As the Board noted, mutual funds are governed by a disinterested board of directors dictated by various independence requirements of the Investment Company Act of 1940, and ultimate control over the funds rests with their boards of directors.

Glass-Steagall. The Glass-Steagall Act imposes limits on banks' involvement in certain securities activities. Section 16 of the Act (12 U.S.C. § 24(7)) places limits on national banks underwriting and dealing in securities and stock and generally prohibits national banks from purchasing or selling securities except upon the order and for the account of customers. Section 20 (12 U.S.C. § 377) prohibits Federal Reserve member bank affiliation with a company engaged principally in underwriting and other securities activities. Section 21 (12 U.S.C. § 378) prohibits organizations that are engaged in underwriting and other securities activities from simultaneously engaging in the business of receiving deposits. Section 32 (12 U.S.C. § 78), prohibits officer, director, or employee interlocks between member banks and companies that are primarily engaged in the securities activities listed in section 20.

The courts have affirmed that activities that are part of, or incidental to, the business of banking are not prohibited by the Glass-Steagall Act.[17] The mutual fund activities in which national banks and their operating subsidiaries engage do not involve underwriting and dealing, so they are not prohibited by section 16. Underwriting and dealing typically refer to a banking entity's purchase of shares for its own account, thereby incurring a principal risk. National banks generally may not engage in distribution or sponsorship of mutual funds and typically employ independent distributors to assume these functions. Activities permitted by Section 16 are not prohibited by section 21.[18] Mutual funds do not take deposits; and while a bank and its subsidiary may receive deposits, they are not engaged in issuing, underwriting, or distributing securities. A bank's sale of mutual funds as agent does not constitute Glass-Steagall distribution, even if the bank also acts as the advisor and/or administrator to the funds.[19]

Section 20 also does not prohibit national banks from engaging in many mutual fund activities because permissible activities do not involve "issue, flotation, public sale, or distribution" of securities. Public sale does not mean sale as a broker but rather sale as an

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[16] See Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993).

[17] See Securities Industry Ass'n v. Clarke, 885 F.2d 1034, 1049 (2d Cir.), cert. denied, 493 U.S. 1070 (1990); OCC Interpretive Letter No. 388.

[18] SIA v. Bd. of Governors of the FRB, 468 U.S. 137, 149 (1984) ("Bankers Trust I"); Bankers Trust II, 807 F.2d at 1057.

[19] See Glidden Letter (January 14, 1988); Interpretive Letter No. 332 (March 8, 1985); see also Federal Reserve Board Sovran Letter (July 1, 1986).

underwriter or dealer.[20] The mutual funds (i.e., investment companies) to which banks and operating subsidiaries provide advice and services may engage in these activities, but they are not "affiliates" of the bank under the meaning of that term in section 20.[21] With respect to section 32, the OCC has not permitted interlocks between the bank and its operating subsidiaries and any entity engaged in "issue, flotation, underwriting, public sale, or distribution" of securities. The directors, officers, and employees of mutual funds and the independent distributor have not overlapped with those of the bank and the operating subsidiaries.

In addition, courts traditionally engage in an analysis based on the legislative history of the Glass-Steagall Act to determine whether the "subtle hazards" that the law was designed to prevent are posed by any proposed activity. These "subtle hazards," which include investor confusion and conflicts of interest, are controlled by the terms of the Investment Company Act, the *Interagency Statement on Retail Sales of Nondeposit Investment Products*, sections 23A and 23B of the Federal Reserve Act, safety and soundness requirements, and supervisory conditions imposed by the OCC.

Operating Subsidiaries. National banks have established operating subsidiaries for approximately 28 years under OCC regulations first issued in 1966. Operating subsidiaries enable banks to use a different organizational structure to conduct permissible activities. The operating subsidiary is subject to OCC examination and supervision and to the same banking laws and regulations as the parent bank, unless otherwise provided by statute or regulation.

The authority for national banks to establish operating subsidiaries is based on the National Bank Act. That Act allows banks to exercise certain enumerated powers and "all such incidental powers as shall be necessary to carry on the business of banking."[22] The Act gives banks broad authority to engage in the business of banking and to exercise powers reasonably necessary to conduct that business.[23]

The incidental powers of national banks include, at a minimum, all powers that are "convenient and useful" to express powers.[24] Many courts and the OCC believe that incidental powers are broader and include activities similar to traditional banking functions. As the Ninth

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[20] SIA v. Bd. of Governors of the FRB, 468 U.S. 207, 218 (1984) ("Schwab").

[21] See 12 U.S.C. 221a.

[22] See 12 U.S.C. § 24(7).

[23] See OCC Letter No. 494 (December 20, 1989), reprinted in [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083.

[24] See Arnold Tours, Inc. v. Camp, 472 F.2d 427, 432 (1st Cir. 1972).

Circuit held in 1977, the incidental powers standard "must be construed so as to permit new ways of conducting the very old business of banking."[25]

The establishment of operating subsidiaries that carry on the business of banking falls squarely within the incidental powers of banks under both the narrow and broader view. These subsidiaries are a "convenient and useful" means of conducting banking business.[26] Because establishment of operating subsidiaries is part of the business of banking, it is not proscribed by 12 U.S.C. § 24(7) provisions prohibiting purchases of corporate stock.

Supervision of Bank Mutual Fund Activities

The OCC has for many years conducted fiduciary examinations of banks that act as investment advisor, transfer agent, or custodian for mutual funds through their trust departments. In addition, bank sales (as agent) of mutual funds are governed by a number of provisions, including 12 C.F.R. 12, which deals with such issues as recordkeeping and notification to customers of securities transactions. OCC examiners have reviewed these activities in conjunction with their examination of banks' investment securities activities. More recently, this aspect of supervision has become part of the OCC's Compliance Program.

While the OCC's experience in supervising the fiduciary and broker/dealer activities of national banks provided a valuable base from which to build, I came to the conclusion shortly after taking office as Comptroller that there was a need for more comprehensive policy guidance. In the past year, the OCC has devoted considerable resources to putting in place procedures for the systematic supervision and examination of the mutual fund activities of national banks. The other federal banking agencies have been grappling with the same issues, and we have coordinated our efforts in order to adopt consistent interagency guidelines.

The interagency statement, entitled *Interagency Statement on Retail Sales of Nondeposit Investment Products*, covers all aspects of a national bank's retail mutual fund sales operation, including sales by bank employees and sales by employees of third-party vendors on bank premises. It makes it clear that banks should view customers' interests as critical to all aspects of their sales programs, and that the federal banking regulators will take appropriate actions to address unsafe and unsound banking practices and violations of law and regulations associated with bank-related sales of mutual funds and other retail nondeposit investment products. Those actions could include civil money penalties, cease and desist orders, and payments of restitution to bank customers.

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[25] M & M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377, 1382 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978).

[26] See 12 C.F.R. § 5.34, and see also 12 C.F.R. § 7.10(c)(2) (repealed).

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To reduce customer confusion between insured and uninsured products, the *Interagency Statement* contains the following specific guidelines:

- Disclosure and advertising for mutual funds and other investment products should clearly indicate that the products are not FDIC-insured, are not obligations of the bank, are not guaranteed by the bank, and involve risk, including the possible loss of principal. Banks should obtain a signed statement from customers acknowledging that they have been informed about the nature of these investment products.

- Bank tellers and other bank employees working in the teller area should not sell uninsured investment products or offer investment advice. Banks should take steps to distinguish between retail deposit-taking and retail nondeposit sales functions.

- A bank should not offer investment products with a name identical to that of the bank. Because of the potential for customer confusion, the guidance warns banks about the risk in marketing investment products with names similar to the bank's name, and provides for heightened scrutiny of programs that use such names.

This emphasis on disclosure and education of bank customers reflects our view that, when properly informed of the nature of the products banks offer, customers will make the choices that best meet their financial objectives. We will monitor how successful these disclosure efforts are in overcoming customer confusion, and as part of a joint project with the SEC, the OCC will evaluate a variety of disclosure tools.

The interagency guidance also addresses the supervision and training of staff who recommend and sell investment products, compensation incentives for staff, and the need to ensure that investment products recommended by the bank are suitable for each particular customer.

In August and September of 1993, the OCC began testing new examination procedures for mutual fund activities of national banks. At the same time, the OCC began training examiners in the use of these procedures. On February 24, 1994, based on experience gained in using the draft procedures in the field, the OCC issued detailed guidance to examiners on retail nondeposit investment products, including mutual funds.

The guidance sets forth the procedures that examiners are to use in evaluating the adequacy of a bank's policies in the following areas:

- Senior management oversight of the scope and direction of the bank's mutual fund (and other retail nondeposit investment sales) activities.

- Qualifications, training, compensation, and adequacy of senior management oversight of mutual fund sales personnel.

- The accuracy and completeness of customer disclosures and advertising, with particular emphasis on the riskiness and uninsured status of mutual fund accounts.

- The bank's procedures for determining the suitability of mutual fund products that they recommend to individual bank customers.

- The use that the bank will make of customer information.

- Compliance with state and federal restrictions on mutual fund transactions involving the bank's fiduciary accounts.

- Oversight of third-party vendors.

Mutual Fund Examinations

The OCC monitors compliance with its mutual fund guidelines through a program of examinations focusing on retail sales of mutual funds and other retail nondeposit investment products. Since the beginning of 1993, the OCC has conducted 337 examinations focusing on mutual funds and other retail nondeposit investment products. A portion of multinational and larger regional banks--which account for most mutual fund sales--were examined during the second half of 1993. The rest of the large banks are scheduled for mutual fund examinations in 1994.

Going forward, the OCC will examine all national banks that sell mutual funds or annuities as part of the OCC's regularly scheduled examinations. The frequency of examination varies from every 12 to every 18 months, depending on the bank's asset size, its overall condition, and the occurrence of a change in control of a bank. Most banks will be examined once every 12 months.

Examiners will use the new examination procedures that I described above. They will review the bank's business plan and its policies and procedures governing its mutual fund operations, its compliance with OCC guidelines, its response to any criticism that the OCC made in previous examinations, and its compliance with all other applicable laws, rules, regulations, and regulatory conditions imposed by bank regulators.

Examinations will be tailored to the scope of the bank's mutual fund sales activities. Large banks that operate their own sales program will initially be examined more extensively than community banks that rely exclusively on independent third-party vendors to operate their mutual fund sales programs. In both cases, however, examiners will expand the scope of the examination to address issues raised in their initial review.

Federal Securities Laws and Regulation

Many banking companies choose to conduct brokerage operations such as mutual fund brokerage in separate subsidiaries or affiliates of the bank. Those separate entities are regulated by the SEC and the NASD in the same manner as any other non-bank broker. Moreover, such entities are subject to additional oversight under the federal banking laws. Similarly, many banks conduct investment advisory activities in separate companies that are regulated under both the Investment Advisors Act and federal banking laws.

Congress provided certain bank exemptions from the federal securities laws by excluding banks from the definition of broker/dealer under the Securities and Exchange Act of 1934 and from coverage under the Investment Advisers Act of 1940. However, banks are still subject to a comprehensive regulatory scheme that addresses many of the same types of concerns as the federal securities laws. For example, those banks that conduct these activities under the exemptions from the federal securities laws are subject to:

- Anti-fraud provisions under Section 10b of the Exchange Act and Rule 10b-5;

- The *Interagency Statement on Sales of Nondeposit Investment Products*;

- Recordkeeping and confirmation requirements for brokerage customers under 12 C.F.R. Part 12;

- Fiduciary regulations at 12 C.F.R. Part 9 and fiduciary obligations imposed by state law;

- The same restrictions that apply to non-bank investment advisors in the Investment Company Act of 1940, for national banks acting as investment advisers to registered investment companies;

- SEC examinations of national banks acting as investment advisers to registered investment companies;

- Restrictions on transactions with affiliates imposed by Sections 23A and 23B of the Federal Reserve Act; and

- Enforcement actions brought by their primary banking regulator, pursuant to 12 U.S.C. § 1818, for violations of any law or regulation, unsafe or unsound banking practices, or for violations of any conditions imposed in writing by the appropriate federal banking agency in connection with the grant of any application or other request by the bank.

Banks are thus subject to a combination of banking and securities laws and supervision by bank and securities regulators. To the extent Congress has exempted certain bank functions

from the securities laws, the primary regulators of banks operating in those areas have the authority and the responsibility to ensure that banks conduct those activities safely, soundly and in the best interests of the investing public. Should the OCC find that additional specific regulation is warranted for these activities, we will certainly take appropriate action, including adopting any needed regulations and/or imposing appropriate conditions in connection with the grant of bank applications related to securities activities.

Coordination with the SEC

The OCC and SEC coordinate their oversight of mutual fund activities in a number of areas.

Joint Examinations. The OCC has proposed to the SEC that the two agencies conduct joint examinations of banks and operating subsidiaries involved in mutual fund sales activities. On February 22, 1994, OCC and SEC staffs discussed developing general guidelines for handling these examinations.

The OCC has proposed to the SEC that the two agencies coordinate examination efforts for banks and operating subsidiaries that are subject to oversight by both agencies. We also proposed coordinating examinations on entities that, although subject to only one agency's oversight, would be relevant to the other agency's supervisory efforts.

For example, the SEC has expressed concern about its inability to examine national bank investment advisory activities. The SEC has the authority to review banks' records relating to mutual funds advised by banks. The SEC would like to review other bank investment advisory records to determine if banks are allocating more favorable trades to particular customers rather than mutual funds. Through our coordination efforts, we should be able to obtain jointly, or to share with each other, information that would permit the SEC and OCC to identify abusive practices. In the past, the OCC and SEC have conducted joint examinations of bank transfer agents.

Sharing Information. The OCC and SEC share a variety of supervisory and examination information. The OCC has provided the SEC access to our reports of examinations, work papers, and examiners in connection with SEC investigations. We also provide information to the SEC to assist it with review of disclosures relating to bank holding companies with national bank operating subsidiaries. The OCC also refers potential violations of law to the SEC and has brought joint enforcement actions in appropriate cases.

The SEC has also provided the OCC with access to its inspection reports and internal memorandum, and referred cases to the OCC.

Disclosures. OCC staff arranged an interagency meeting with staff of the SEC, the Federal Reserve Board, and the Office of Thrift Supervision to discuss coordinating banking

agency disclosures with the SEC's disclosures. We discussed the possibility of developing consistent disclosures for both bank regulatory purposes and for SEC requirements, particularly with regard to the SEC's required disclosures on the cover page of the prospectus. We also discussed the SEC's plans to handle situations where funds are sold in bank-related sales without the required disclosures on the prospectus.

Finally, OCC staff also discussed with the SEC that the Investment Company Institute (ICI) had written to all of the agencies suggesting that we consider consistent disclosures for money market funds. The ICI asked that we consider coordinating the banking agencies' loss of principal disclosure with the SEC's warning that the constant net asset value may not be maintained.

Mellon/Dreyfus

Under OCC regulations, a national bank that intends to acquire, establish, or perform new activities in an operating subsidiary must notify the OCC before doing so. The bank may proceed with its plans unless the OCC notifies the bank within 30 days that creation of the subsidiary raises issues that require additional information or additional time for analysis. In that event, the bank cannot proceed until it receives written approval from the OCC.

On December 30, 1993, Mellon Bank, N.A. filed notice with the OCC of its intention to acquire the Dreyfus Corporation (Dreyfus) as an operating subsidiary of the bank. Dreyfus proposes to engage only in activities that the OCC has previously found to be permissible for national banks and their operating subsidiaries, such as brokerage services, investment advice to mutual funds and the public, and administrative services to mutual funds and their shareholders. Dreyfus would not engage in the underwriting, issue, flotation, public sale, or distribution of securities--activities which the Glass-Steagall Act generally prohibits for national banks. The OCC publicly announced the receipt of the Mellon notification in the OCC's Weekly Bulletin, as we do for all operating subsidiary notifications. On January 5th, the OCC notified Mellon that it was extending the 30-day period to allow for thorough review of this complex transaction.

As part of the notice, Mellon made various factual representations and commitments concerning the proposed activities of Mellon and Dreyfus. The representations and commitments are aimed at ensuring that the transaction is consistent with bank safety and soundness requirements, consumer protection, and various legal requirements. In particular, the representations and commitments relate to transactions between the bank, the subsidiaries, and the mutual funds; transactions between the bank and the subsidiaries and the third party distributor; disclosure matters; conflicts of interest; and other important issues. Mellon also provided a Policy Statement on Mutual Funds that addresses many of these matters. Mellon and Dreyfus, in a letter to Chairman Dingell dated February 18, 1994, indicated their willingness to have the commitments set forth in the Policy Statement become conditions of regulatory approval. Although the OCC has made no final decisions, if we were to approve the

notice, the written conditions the OCC, at a minimum, would likely impose would cover the voluntary commitments set forth in the Policy Statement.

Under previous Comptrollers, the OCC has not generally provided for formal public notice and comment on operating subsidiary filings, reasoning that any activity that would be judged permissible in an operating subsidiary would by definition be permitted without prior notice in the bank itself. I believe, however, that public comment may be appropriate in cases where the nature of the activities to be carried out in the operating subsidiary, the size of the transaction, or other unusual factors raise special legal or policy issues. I have therefore initiated a review of the OCC's policies in this area, and I plan to request comment on a proposed rule that would require publication of notice in the Federal Register of operating subsidiary notifications that raise novel questions of law or policy.

In light of the novel and complex issues raised by the Mellon proposal--and also by First Union National Bank's similar proposal to acquire Lieber and Company and the Evergreen Asset Management Corporation--we have decided to publish these two proposals for public comment. The comment notice appeared in the *Federal Register* on February 23, 1994. We look forward with great interest to the comments that we will receive, and we are confident they will improve the quality of our decisionmaking process.

The OCC is currently reviewing Mellon's proposal to ensure that all of the proposed activities are, in fact, permitted by law. We will not approve the proposal unless this is the case. We are also evaluating the management controls proposed for both Mellon and its operating subsidiary, including the adequacy and independence of management and board oversight and other control systems, the business plans and strategies of both Mellon and Dreyfus, and their written policies and procedures, audit programs, and compliance programs. Our review places particular emphasis on the controls governing the relationship between Mellon and Dreyfus, and on the safeguards that will help to ensure that customers understand which products offered by the combined entity are federally insured and which are not.

Because bank operating subsidiaries involved in mutual fund activities are also regulated by the Securities and Exchange Commission, we are coordinating our review of the Mellon proposal with the SEC. We have met with senior SEC staff to discuss the SEC's general procedures for supervising mutual fund companies such as Dreyfus. We also inquired specifically about the SEC's experience regulating Dreyfus, and asked whether the SEC had any particular concerns that we should be aware of as we process Mellon's proposal.

After the OCC concludes its review of the proposal, we will decide whether to approve the proposal, and--if the decision is to approve--what special conditions should be placed on Mellon or Dreyfus beyond those offered in the proposal.

Safety and Soundness Issues. The OCC is carefully evaluating the safety and soundness implications of the proposed acquisition, including the fact that Mellon is proposing to operate Dreyfus as an operating subsidiary. The safety and soundness issues raised by this proposal are

similar to those involved in other operating subsidiary proposals involving mutual funds that the OCC has approved. Nevertheless, the volume of business that Dreyfus would bring to Mellon makes this proposal unique.

The principal financial risks posed by mutual fund operations include liquidity risk (the risk that a bank will cover losses arising from a fund's inability to meet redemption requests), operational risk (the risk that a bank will suffer losses because it lacks necessary expertise or operational infrastructure), and legal risk (the risk of losses due to lawsuits brought by customers or enforcement action brought by the bank's regulators). These and other risks are not unique to mutual funds; they arise in other banking activities as well. Whenever the OCC evaluates a proposal for a bank to set up an operating subsidiary, we consider the adequacy of the controls to deal with these risks. Risk management is also a central focus of OCC examinations, for mutual fund activities carried out in banks, in operating subsidiaries, and through third-party vendors.

From the perspective of bank safety and soundness, the most serious concern raised by a proposal such as Mellon's is the possibility of exposure to operational or fiduciary losses in its mutual funds subsidiary. Bank managers might feel strong pressure to reimburse an affiliated mutual fund or its customers for market losses, particularly if a money-market mutual fund managed by the bank would otherwise fail to maintain a constant net asset value. Bank managers might also feel pressure to provide emergency credit to or investments in a mutual fund subsidiary to cover an unexpected surge in redemptions.

We are looking closely at the Mellon/Dreyfus proposal to determine whether it contains adequate safeguards against any such depletion of bank capital. In cases where operating subsidiaries would otherwise pose an unacceptable risk to bank capital, the OCC has limited, as a condition of approval, the amount that a bank may invest in its operating subsidiary. If circumstances warrant, we can place similar limits on Mellon.

But it is important to keep this risk in perspective. The possibility of loss to the parent bank is not unique to mutual fund subsidiaries: it exists with respect to activities conducted in a division of the bank itself. Mutual fund sales pose less risk to banks than many more traditional banking activities, since the risk that the mutual fund's holdings could decline in value is borne by the customer rather than the bank; although a sharp decline in the market could increase mutual funds' liquidity risk.

We also need to ensure that the operations of the parent bank do not endanger its mutual fund subsidiary. In particular, the Dreyfus Corporation currently holds far more capital than is required by the SEC's capital requirements. This capital for the most part reflects direct investments by Dreyfus, by virtue of which Dreyfus shareholders benefit from the firm's investment management capabilities. The surplus capital cushion also provides an extra margin of protection to Dreyfus customers.

If the OCC decides to allow Mellon to acquire Dreyfus as an operating subsidiary, Dreyfus's excess capital will strengthen the balance sheet of the combined entity. This improvement in Mellon's capital position will not come at the expense of Dreyfus customers, as long as Mellon is adequately capitalized in light of all the risks faced by the combined entity. The OCC is currently reviewing Mellon's proposal to determine what effect the consolidation of Mellon and Dreyfus would have on Dreyfus's net capital ratio. If the OCC approves the transaction, we will insist as a condition of approval that Dreyfus remain in compliance with all financial responsibility standards, including the capital requirements established by securities laws.

Conflict of Interest Issues. In addition to posing risks to the bank, and to customers who misunderstand the risks of their mutual fund investments, mutual fund sales and other mutual fund activities can give rise to potential conflicts of interest. For example, a bank could be open to charges of conflict of interest if it lent to a company whose securities were held by a bank-managed mutual fund, if the mutual fund made off-market purchases of securities from the bank's investment account (or from bank customers or creditors), if the mutual fund invested funds in securities which assisted a bank customer in paying off bad debts to the bank, or if a fund manager traded on his own account in advance of a trade of the same securities on the fund's account. The absence of strong controls could result in charges of self-dealing and possible financial liability. In reviewing Mellon's proposal to acquire the Dreyfus Corporation, the OCC is considering the potential for conflicts of interest and the policies and procedures that Mellon would use to identify and avoid possible conflicts.

Here too, however, it is important to put the issue in context. The same kinds of issues arise when banking firms have securities subsidiaries--or, indeed, trust departments. Both the banking industry and its regulators have a long history of experience in this area. Banking and securities laws, rules, and regulations include a broad range of conflict of interest restrictions designed to ensure that bank customers and mutual fund customers are not placed at a disadvantage by insiders. These restrictions cover banks acting in their fiduciary capacity as well as banks serving as broker-dealers for their customers. Banks providing investment advice to mutual funds are also subject to a host of disclosure requirements and prohibitions against self-dealing.

Because a breach of a bank's obligations to its customers can expose the bank to significant legal liability, banks generally adhere to internal conflict of interest policies above and beyond the regulatory requirements. One of the primary functions of the OCC as regulator is to ensure that these internal systems and controls meet or exceed legal requirements and are enforced. Our examination experience in this areas indicates that bank managers and directors share our concern for implementation and enforcement of strict conflict of interest policies.

Conclusion

Our nation needs a strong banking system--not for the sake of having a strong banking system--but for the sake of the public. We need a banking system that can foster economic growth, and enable disadvantaged people to participate in that growth. For our banking system to remain strong, banks must be able to respond to changes in the market for financial services. To prohibit banks from responding to change would reduce both competitiveness and safety and soundness. To reduce the range of products and services from which consumers may choose would impoverish our marketplace and our economy.

One of the clearest changes in the past decade has been the growing role of mutual funds in the financial services industry. With appropriate protections for consumers and safeguards aimed at maintaining safety and soundness, banks can take part in that change. Banks are well positioned to meet customer needs in the mutual fund market, due to their extensive network of branches, which reaches into virtually every community in the nation; their long-standing tradition of fulfilling the fiduciary needs of their customers; and their established relationships with most of the nation's households. Bank sales of mutual funds, whether through an operating subsidiary or directly from the bank, can be fundamentally beneficial to the banking public. They offer customers greater convenience and greater choice in shopping for mutual fund services, and permit banks to compete on an equal footing with other providers of financial services.

But the rapid growth in bank sales of mutual funds also raises a number of serious policy issues that regulators and the banking industry need to address. Bank mutual fund operations must incorporate adequate customer protections and safeguards against potential conflicts of interest. They must not endanger the financial soundness of banks or their mutual fund subsidiaries. They must observe legal limitations on permissible banking activities, and they must be adequately supervised. We are weighing these issues, as well as the specific circumstances of Mellon Bank, as we consider Mellon's proposal to acquire the Dreyfus Corporation.

Mr. DINGELL. The Chair thanks you very much for your statement.

Ms. Broadman, do you have any comments you would like to make?

Ms. BROADMAN. I do not.

Mr. DINGELL. Very well.

The Chair recognizes the gentleman from Colorado for questions.

Mr. SCHAEFER. Thank you, Mr. Chairman.

Thank you, Mr. Ludwig and Ms. Broadman for being here today.

Yesterday's and today's hearings have been so focused on the actual and potential problems of sales of securities at banks that some people may be wondering why it was ever contemplated in the first place. What are the advantages of permitting customers to buy securities at banks?

Mr. LUDWIG. Well, I think there are genuine advantages. Banks offer competition, they offer consumer choice. The very fact that consumers are buying mutual funds from banks in record numbers, to a considerable degree, testifies to consumer desires. So I think there are genuine benefits to banks' being involved in this activity.

Mr. SCHAEFER. Well, you have mentioned competition, what are the competitive advantages? I mean, if somebody wants to buy securities, what is the difference?

Mr. LUDWIG. There are a couple of points worth making here. In any market, the fact that you have more market participants increases the level of competition, and drives down price, and increases choice. Moreover, banks are located in areas that are often underserved by other players. There are thousands of bank branches, and banks have community responsibilities, CRA responsibilities, that other participants in this market do not.

Mr. SCHAEFER. So, in other words, a bank merger with securities then is going to be advantageous to the consumer?

Mr. LUDWIG. There are serious consumer issues here, there is no doubt, and we take those very seriously. But I believe that in judging whether or not banks ought to be in mutual funds that, in fact, they should and that the consumer benefits outweigh the negatives.

There are serious questions here, to be sure, and we are going to address them as vigorously as is necessary but, at the same time, it seems to me that there are a variety of different reasons why this kind of activity is an appropriate activity for a banking organization.

Mr. SCHAEFER. As long as we steer away from problems such as occurred with Keating and Continental?

Mr. LUDWIG. Absolutely.

Mr. SCHAEFER. We had AARP in here saying that, gosh, you have to look at the fine print on the last page to see whether or not you are FDIC insured.

Mr. LUDWIG. We have to be very vigorous in those areas, and I believe we have a quality examination team properly focused and we are giving it proper focus to achieve the necessary consumer protections.

Mr. SCHAEFER. What is OCC's examination process for banks' sales of nondeposit investment products?

Mr. LUDWIG. We have traditionally had significant trust specialist examiners that go into all the banks we supervise. We have 3,300 examiners for roughly the same number of banks, basically one examiner per bank. Part of the examination effort is in the trust area and the mutual fund area. I do not believe that this has been adequate.

One of the things I have done since I became Comptroller is to recognize there is a huge growth in this area and that we really want to aggressively focus our attention on the growing mutual fund area to make sure consumers are protected. Our new mutual fund examiner guidance is very detailed. It is based on a lot of testing that we have engaged in in terms of review of what we do in the examination. I think it is a good examination procedure and it will be applied at every single national bank in this country within the next year.

Mr. SCHAEFER. When you do evaluate, what criteria do you use when you are checking these banks out?

Mr. LUDWIG. We evaluate on the basis of banks' disclosure and their policies and procedures for suitability. We examine on the basis of whether or not we have conflicts of interest. A panoply of issues that are attendant on the sales of these kinds of noninsured investment products. The examination guidance itself runs to about 30-plus pages. If it is not adequate on a going-forward basis, I am committed to continually improving and modifying in this area so that we get it right. This is an important area and we take it very seriously.

Mr. SCHAEFER. What kind of training do these examiners go through? I mean how intensive is it?

Mr. LUDWIG. We have training facilities all over the United States at our district offices. We have six district offices, and we also train here in Washington. Our examiners themselves go through a period of apprenticeship and training before they become commissioned examiners. Even after they become commissioned examiners, they are frequently brought into these training centers for specialized training in new developments and new rules. Moreover, we send out circulars and have conferences. We have a significant training operation.

Mr. SCHAEFER. Are there any updated criteria to this training? Are there tests that you run, or is there testing involved once they have completed this training? I mean, we pass new bank laws all the time here in Congress, I mean, is there any update that do you on this?

Mr. LUDWIG. Well, I would be happy to go over our training and submit the entire comprehensive nature of our training for the record. Our examiners, before they become commissioned examiners, do indeed have to pass a test.

Mr. SCHAEFER. But do they have to go back and be retrained as things change with banking laws here in the Congress?

Mr. LUDWIG. Yes, absolutely.

Mr. SCHAEFER. They do. Does your office plan to use undisclosed testers or examiners to go out and check on these individual banking operations to find out how they are operating?

Mr. LUDWIG. We have attempted, as I hope you heard from my oral testimony, to be increasingly aggressive to make sure the

consumer is protected. The new examination guidelines really will involve very extensive examinations of these banks in the mutual fund area. In our interagency guidance, we encourage banks to use their own testing program, and we will be testing their policies and procedures in this area.

Whether or not we use our own testers, I have been the most aggressive of the Federal financial services regulators in developing a testing program for bias in the lender area in terms of race and other illegal discrimination, and I must say that I am drawn to the notion that maybe this is an area as well that deserves mystery shoppers or testers, third party testers, and we are considering that actively at this time.

Mr. SCHAEFER. So you are not doing it at the present?

Mr. LUDWIG. But we are not doing it at the present time.

Mr. SCHAEFER. What enforcement of punitive measures do you or will you take when a bank does not comply with the interagency statement on retail sales of nondeposit investment products. Is this any different a policy for a bank's failure to comply with its own policies or procedures?

Mr. LUDWIG. I think to understand the guidance, you have to understand it in the context of our supervisory effort, which is an effort that is very much linked to a sort of continuing examination and supervision of these financial entities. Each of the financial supervisory efforts has its benefits and its burdens, none is perfect.

One of the advantages of ours is that we have a significant number of personnel that examine these institutions on a regular basis, and quite frequently, based on guidance and regulations, we demand change. Our supervisory structure is sufficiently active so that we get change.

Let me say that the guidance, however, is completely enforceable with our 1818 powers which give us broad enforcement powers, including civil money penalties and cease and desist orders, and even so far as removal, taking action to remove a bank officer if necessary. We can do that where the safety and soundness of the institution is threatened. So that, even though this is guidance, I know the issue has been raised of how far can you go with guidance, we are confident that we can use the full panoply of our resources.

Mr. SCHAEFER. Well, outside the Mellon-Dreyfus proposed merger, the First Union Bank of North Carolina has also filed a notice with the OCC to acquire two corporations which manage and advise mutual funds. Are there any new regulatory or legal issues which these acquisitions present as compared to the Mellon-Dreyfus proposal, and what control system do you envision being necessary to ensure First Union's customers adequate protection and disclosure?

Mr. LUDWIG. I would be pleased to discuss with the committee, to the extent I am able under ethical rules, these individual applications, but as a matter of fact we don't discuss individual applications to a great degree publicly. Let me say this, however, in answer to your question——

Mr. SCHAEFER. Were there any new legal issues raised?

Mr. LUDWIG. Each of these applications presents complex situations that deserve serious examination before they are approved,

and I intend to give them a serious look. I have no idea how we will come out.

At the same time, let me say that the activities, generally speaking, which have been proposed here are similar to activities that we have already approved for banks and for bank operating subsidiaries, so that in the main the activities are not distinct from activities that have already been approved. But we look at each of these individual submissions very carefully in terms of the safety and soundness of the institution and the well-being of the public and in terms of what commitments there are or there aren't, conditions we might impose, and it is a individual look.

Mr. SCHAEFER. Well, my time is expired, but the First Union Bank of North Carolina certainly is a much smaller type of acquisition than the Mellon-Dreyfus, which I think maybe has raised some flags based on the sheer size of it.

Mr. LUDWIG. The First Union is indeed smaller than the Mellon-Dreyfus proposal.

Mr. SCHAEFER. Thank you very much, Mr. Chairman.

Mr. DINGELL. The Chair recognizes the gentleman from California, Mr. Moorhead. The Chair advises that the Chair is recognizing members for 10 minutes instead of five.

Mr. MOORHEAD. Thank you, Mr. Chairman. Many senior citizens depend on their banks or their banker for their financial advice, for consultations of all kinds. I know many of them that would not do a thing without going to their banker and talking to them. There is a profit motive in selling mutual securities, of course. They are nowhere near as dangerous as junk bonds can be. I know the problem because so many of them in the Keating case were sold in my area—was that they were led to believe by their banker that the junk bonds were safe, even though they were not insured by the Federal Government—that they were as safe as anything could be because this powerful institution that they had total trust in was behind it.

I think it is essential that, if the banks are to sell mutual funds or any other securities that the people that buy them should not only be told that they weren't federally insured, but they should be told that they can lose money on it as well as make money—that you do get bad days on the Stock Market, when the Stock Market drops out. So many of these people, when they are senior citizens cannot afford to lose anything. I have had some tragic cases come to me in my office about people who have lost on the Keating thing. I have confidence in mutual funds, so I am not tearing that down; but, I think it is most important that if a bank is going to sell these items, whether it is regular stock or whatever it is that are not insured, that they are told they can lose money on them. If the bank is not behind the security is such, it cannot affect the cost because when the market goes down it goes down and the stocks that the mutual fund has an interest in, when they go down, the value that that senior citizen may have also goes down.

Do you agree with me on that?

Mr. LUDWIG. I absolutely agree with you. This is a genuinely serious problem. The disclosures and the need for disclosure certainly goes beyond the mere fact as to whether or not they are insured. Indeed, our interagency guidance requires a disclosure that—not

just that they are not federally insured, but also that they are not obligations of the bank, they are not guaranteed by the bank, and that you can lose money on investments. That is in the interagency policy guidance. We expect that message to be delivered to bank customers. It is very, very important that that happen.

I must say I am worried beyond just banks. That is, some of the studies we have looked at show broad confusion among mutual fund purchasers of nonbank providers. So, this is a serious problem, and we intend to deal with it seriously.

Mr. MOORHEAD. In testimony yesterday, the Chairman of the SEC characterized the role of the SEC as investor protection. Does the OCC also view its role as one of investor protection when it regulates the securities sales activities of banks?

Mr. LUDWIG. We very much view our role as one of protecting the consumer, as well as protecting the safety and soundness of the institution. We view that as one of our responsibilities and we intend to take it seriously.

Mr. MOORHEAD. In carrying out your role, how do you describe this role and your responsibilities when you seek the protection of depositors?

Mr. LUDWIG. In this area, we have tried to deal with the problem in a variety of different steps. Using our examiner force and our examiner guidance will help tremendously to ensure that the proper disclosures are made and to take action when they are not. In terms of getting the industry groups together, I take some pride that for the first time, they are coming together, issuing a policy-level statement themselves and in getting that out to the institutions that are their members.

We have, as I said, issued brochures that some of the consumer organizations themselves have distributed and some of the banks have distributed, so that we are trying to deal with this problem in a variety of different ways that we believe will be effective.

Mr. MOORHEAD. Is there a conflict between OCC's role as an investor protector and the role of protector of the depositor? Are the depositors better off as the bank makes profits from selling mutual funds and so forth, and yet to protect the role of the investor maybe slightly a different role? They do not care whether the bank makes a profit, they care whether what they buy——

Mr. LUDWIG. One of the things that makes banks sound, seems to me, is the consumer belief that they are institutions of integrity. I cannot imagine having a safe and sound banking organization that does not treat its customers in an appropriate fashion. So, I think that the safety and soundness of the institution are genuinely linked to their role as living up to appropriate consumer protection standards.

Mr. MOORHEAD. Does the OCC believe that the same information that is available for the depositors should also be made available to the investors?

Mr. LUDWIG. We certainly have focused on making available to investors information and disclosures. I would like to reserve on that question, in the sense that we certainly want full disclosure for investors and depositors. There is no reason I can imagine why you would not want to give the same kinds of information to both, as long as the proper disclosures are carefully made so there is no

confusion. I want to think about that question a little more and submit additional information to you.

Mr. MOORHEAD. Under the proposed transaction, Mellon will acquire Dreyfus as a subsidiary of the bank, not as a subsidiary of the bank holding company. I understand that this means the Comptroller of the Currency will rule on the application, instead of the Federal Reserve Board. What are the implications of this, in terms of the safeguards that might be found in one structure but not in the other?

Mr. LUDWIG. There are burdens and benefits to the use of these structures, and they all have to be examined very carefully. One of the advantages to an operating sub of the bank is that the capital and income flow into the bank and are consolidated with the banks, so that the bank has a call on the capital to a degree where it is appropriate, and it also has the income stream. There are a variety of benefits that flow from that in terms of the bank's safety and soundless, and the safety and soundness of the whole entity. In addition, because the banks have consumer responsibilities arising out of the Community Reinvestment Act, there are other benefits that accrue to the community.

There are issues here. There are issues of separateness. There are issues of protection, both of the bank and of the subsidiary, that have to be dealt with. There are differences. We intend to look at these differences very closely to make sure there is protection before we approve these applications, and where conditions can resolve any difficulties, we will do that.

Mr. MOORHEAD. It seems that banks have been dealing with mutual funds in one way or the other for some time now. You have been monitoring that activity to a great extent. Is there anything unique about the arrangement we will find with this merger that is different or presents new problems that you have not seen before?

Mr. LUDWIG. As I said earlier to Congressman Schaefer, each application presents its own particular set of issues that have to be carefully looked at. In the main, these activities have been approved for banks and operating subsidiaries. Although we have to take these transactions very seriously, these transactions, at the same time, in the main, these kinds of activities have been approved for banks and operating subsidiaries.

Mr. MOORHEAD. I see the red light has come on, so I yield back the balance of my time.

Mr. DINGELL. The Chair thanks the gentleman. Mr. Ludwig, welcome to the subcommittee. Now, what language in your statute specifically requires you to protect investors?

Mr. LUDWIG. We have general chartering responsibility, in terms of these chartered entities, meeting the convenience and needs of the community.

Mr. DINGELL. You are telling me you have no specific powers or direction to protect investors on securities that are sold out of the banks?

Mr. LUDWIG. No, sir. I do not believe that——

Mr. DINGELL. What specific statutory authority do you have on that?

Mr. LUDWIG. In 12 USC 1818——

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG. In 12 USC 1818, which are enforcement authorities, we have broad responsibilities to enforce in order to protect the safety and soundness of the institution. As I mentioned before, we believe that that safety and soundless responsibility also requires us to make sure that customers are well-protected.

Mr. DINGELL. Now, tell me what 12 USC 1818 does. It goes to unsafe and unsound banking; does it not?

Mr. LUDWIG. It also requires, sir, that we must make sure the banks comply with all laws, including the fraud laws.

Mr. DINGELL. All the laws, including fraud?

Mr. LUDWIG. Including——

Mr. DINGELL. So, a bank cannot commit fraud?

Mr. LUDWIG. A bank cannot violate any laws. If it does, we——

Mr. DINGELL. Now, tell me where that has been construed by yourself or by the courts to relate, let's say, to bad advice to investors, or where it has been construed to relate to inadequate supervision of employees or broker-dealers who are employed within the bank? Has that ever happened?

Mr. LUDWIG. Part 9 of——

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG. Part 9 of our regulations, which deal with——

Mr. DINGELL. I am asking you about the statute.

Mr. LUDWIG. I—the——

Mr. DINGELL. Where is that?

Mr. LUDWIG. PART 9 PLACES A VARIETY OF FIDUCIARY RESPONSIBILITIES ON BANKS.

Mr. DINGELL. Is that with regard to depositors, or is that with regard to any person with whom the bank does business?

Mr. LUDWIG. That is with regard to people who do business with the bank in a fiduciary capacity.

Mr. DINGELL. Have you ever used 12 CFR Part 9 to protect an investor in a mutual fund or a purchaser of securities from a bank?

Mr. LUDWIG. We have used that regulation in terms of the protection of trust customers and other customers who deal with the bank in its fiduciary capacity. We believe that when a bank engages in a mutual fund activity, it is dealing with the customer in a fiduciary capacity. So, Part 9 applies to the bank's activities. Now, we can use our Part 9 and our 1818 authorities, in terms of enforcement in the mutual fund area.

Mr. DINGELL. Well, let's talk about the average bank mutual fund investor. Is he a sophisticated investor or an unsophisticated investor?

Mr. LUDWIG. I am sure that there are bank mutual fund customers that run the gamut of sophistication.

Mr. DINGELL. He is also quite often a person of modest income?

Mr. LUDWIG. There is no distinction in terms of banks serving customers, whether or not they are of high or low income.

Mr. DINGELL. Now, trusts——

Mr. LUDWIG. I would imagine that there are certainly those that serve——

Mr. DINGELL. Trusts, however, are typically the province of the wealthy; isn't that right?

Mr. LUDWIG. Trusts can be the province of the wealthy, or they can be a method——

Mr. DINGELL. They usually are, aren't they?

Mr. LUDWIG. It is more common that people of some means use trusts.

Mr. DINGELL. Banks usually do not like to piddle around with small trusts; they like the bigger ones, don't they?

Mr. LUDWIG. Well, sir, I think that, if you look at the banks in this country, there are about 14,000 depositories, and some of these institutions are really quite small. Some of them are $15, $20 million institutions in small towns that deal in small loans, and in a variety of relationships, with customers of very small means.

Mr. DINGELL. So, you are telling me that you have used these powers in connection with the trust activities of the bank? Have you ever used it with regard to misrepresentations connected with the sale of mutual funds or securities?

Mr. LUDWIG. As I mentioned, the mutual fund activity was going on in the banks long before I became Comptroller.

Mr. DINGELL. I know that. That is why I am asking you have you ever used these powers in connection with misrepresentations or other misbehaviors in connection with mutual fund sales?

Mr. LUDWIG. I cannot answer that question because I do not know the answer, but I will get back to you in writing for submission to the record.

Mr. DINGELL. You are telling us that you cannot recall any instance where you have done that; is that right?

Mr. LUDWIG. Well, I have been in office 11 months. As I have said, we intend to be very aggressive in this area, and we certainly intend to use these powers on a going-forward basis in the mutual fund area where there may be violations.

Mr. DINGELL. So, what you are telling us now is that you cannot recall any instance in which the Office of the Comptroller of the Currency has taken such action. Can you tell us of any instance where you have sanctioned a bank or taken direct regulatory action against a bank for their failure to adequately and properly protect the investor or the consumer in connection with the sale of mutual funds?

Mr. LUDWIG. Well, I can say that, over the last 11 months, as we have been beginning to review banks under our new approach to mutual fund guidance——

Mr. DINGELL. You are describing a new approach, but I am asking you about history.

Mr. LUDWIG. We have not——

Mr. DINGELL. Mr. Ludwig——

Mr. LUDWIG. Excuse me.

Mr. DINGELL.You are a highly-intelligent man, and you are very sophisticated, and you are the head of a major Agency. I am just a poor Polish lawyer, and all I am trying to do is to get you to give me a yes or no answer. Have you ever sanctioned or has your Agency ever sanctioned any bank for any impropriety in connection with mutual fund sales?

Mr. LUDWIG. I guess, number one——

Mr. DINGELL. Just, yes, you have, or no, you have not, or you do not know.

Mr. LUDWIG. We have, in fact, required banks who are selling mutual funds to change their practices within the last year.

Mr. DINGELL. That is not a sanction, is it? A sanction is where you punish someone for wrongdoing. Now that we understand that, have you ever sanctioned a bank for improprieties in connection with mutual fund sales?

Mr. LUDWIG. I will have to get——

Mr. DINGELL. Yes, you have or no, you have not, or you do not know?

Mr. LUDWIG. No.

Mr. DINGELL. Which of the three?

Mr. LUDWIG. I do not know the answer to that question.

Mr. DINGELL. Very good. Let us then proceed.

Yesterday we heard a number of examples about how banks currently are not being candid with consumers in ads, brochures and sales pitches. Potential buyers are not being told that mutual funds are not being covered by FDIC insurance. In other cases, the disclaimers regarding FDIC insurance are put out in tiny print as a footnote in the brochure. At other times, there is a deliberate attempt to make SIPC insurance look like a substitute for FDIC insurance. These and similar practices have led to consumer confusion and have resulted in consumers taking money out of insured instruments, such as certificates of deposit, and putting them into what they believed were insured money market funds. Can you cite any instance in which you have taken regulatory action against these types of practices?

Mr. LUDWIG. Mr. Chairman——

Mr. DINGELL. Either you have taken such action or you have not. Which is the case?

Mr. LUDWIG. Mr. Chairman, since I have been in office, for 11 months, we have——

Mr. DINGELL. Beloved friend, 11 months is enough to know whether you have taken sanctions or whether you have taken actions on this kind of misbehavior. You have known for some time that you were going to be before this subcommittee and I assume you prepared for it.

I assume that, if you had a story to tell us about your action and the action of your Agency in connection with misbehavior of this sort, you would have been ready to tell us.

Now, am I incorrect in that assumption or not?

Mr. LUDWIG. Sir, we have been active in this area, but we have not——

Mr. DINGELL. Let me just ask you——

Mr. LUDWIG [continuing]. We have not taken sanctions during my term thus far against——

Mr. DINGELL. Well, has any such sanction ever been taken during the career of your predecessor?

Mr. LUDWIG. Let me say this—that there were, last year, 14 consumer complaints; 15,000 complaints came into our office about banks in the last year and 14 involved mutual funds. We became involved in seven of the transactions and sent a letter to the bank—for seven of the transactions, there was restitution or they were unwound. Now, we did not take a sanction in a formal——

Mr. DINGELL. Would you make those——

Mr. LUDWIG [continuing]. Sense; but, in fact, those transactions——

Mr. DINGELL. Would you make those complaints to which you have just alluded available to the committee?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Together with a statement on what action you have taken?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Now, let's look at this. $2 billion a week is going into mutual funds, and two billion is going into purchase of bank-managed or operated mutual funds. Now, in 11 months, that means that you have seen approximately $100 billion in sales since you took office. Is that a fair number?

Mr. LUDWIG. I can get back to you on the number. I am not certain there had been that much in terms of sales of bank mutual funds, but I can get back to you on the exact number. I do not know the exact number.

Mr. DINGELL. That is just mutual funds. Now, in your concluding remarks, Mr. Ludwig, you say this: "The rapid growth in bank sales of mutual funds also raises a number of serious policy issues that regulators and the banking industry need to address. Bank mutual fund operations must incorporate adequate customer protections and safeguard against conflicts in interest." Do you agree with that statement?

Mr. LUDWIG. I certainly agree with that statement.

Mr. DINGELL. Now, what specific actions have you taken against conflicts of interest by bank sellers of mutual funds or their employers? Do you have in place a rule against frontrunning? You know what frontrunning is, don't you?

Mr. LUDWIG. I understand what frontrunning is.

Mr. DINGELL. Do you have a rule in place against frontrunning?

Mr. LUDWIG. We have rules in place against frontrunning.

Mr. DINGELL. What are those rules, please?

Mr. LUDWIG. That is in our Part 9 of our——

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG.In Part 9 of our regulations. We will provide——

Mr. DINGELL. Part 9?

Mr. LUDWIG. We will provide you with that.

Mr. DINGELL. Will you submit that to us, for purposes of the record, so we can know what that is?

Mr. LUDWIG. Yes. Excuse me. I was corrected. It is Part 12, not Part 9 of the regulations. Part 12.

Mr. DINGELL. Do you have—well, let's read Part 12. Part 12, the headline of it says: "Record-keeping and Confirmation Requirements for Securities Transaction." Where is frontrunning in there?

Mr. LUDWIG. We were——

Mr. DINGELL. Where is frontrunning in there?

Ms. BROADMAN. If I could just add? There is a——

Mr. DINGELL. I have a hard time hearing you, so you are going to have to speak up, Ms. Broadman.

Ms. BROADMAN. Please let me know if you cannot hear me. Can you hear me now?

There is a provision in our regulations that requires bank employees who are providing advice to disclose all of their personal

trades to the bank so that the bank can monitor this for frontrunning.

Mr. DINGELL. Where is that?

Ms. BROADMAN. I am sorry, I do not have Part 12. If I could look at that, I could find it for you quickly. It is toward the end.

Mr. DINGELL. Well, does this prohibit conflict of interest? Does it specifically address the question of frontrunning?

Ms. BROADMAN. Well, banks——

Mr. DINGELL. Yes, it does, or no, it does not? Please—I do not have time for this.

Ms. BROADMAN. OK. Yes. Let me explain.

Mr. DINGELL. It does prohibit frontrunning or it does not? Yes, it does, or no it does not.

Ms. BROADMAN. OK.

Mr. DINGELL. Now, which answer do you choose?

Ms. BROADMAN. Yes, if you are talking about frontrunning, which constitutes a breach of fiduciary duty.

Mr. DINGELL. How does it prohibit frontrunning?

Ms. BROADMAN. OK. Banks who are providing investment advice have fiduciary duties. They are subject to Part 9. They cannot engage in conflicts of interest. We have provisions that prohibit them from engaging in activities that represent a conflict of interest. We also require full disclosure of their personal trading activities, so that the banks and the examiners can monitor and pick up activities that represent conflicts.

Mr. DINGELL. You do not remember where this rule or regulation is, do you?

Ms. BROADMAN. If you would give me Part 12, if I may approach, I would be happy to find it.

Mr. DINGELL. All right. Now, what do you have that would prohibit a specific conflict of interest of selling a stock in a mutual fund in which that employee would have some interest? Where is that in the rules or regulations?

Mr. LUDWIG. That would be in Part 9.

Mr. DINGELL. Pardon?

Mr. LUDWIG. That would be in Part 9.

Mr. DINGELL. Part 9? Now, what is the——

Mr. LUDWIG. Part 12 deals with the disclosure of the employee, and Part 9 deals with the fiduciary responsibilities.

Mr. DINGELL. There is a big difference between disclosure and a specific prohibition, is there not? You are telling me that they are required to disclose?

Mr. LUDWIG. Part——

Mr. DINGELL. You are not telling me that there is a specific prohibition there. Now, what are your rules with regard to supervising the employees? Let me read you the language here. It says: "Excluded from this requirement are transactions for the benefit of the officer or the employee over which the officer or employee has no direct influence or control, transactions in mutual fund shares or U.S. Government or Federal agency obligations, and all transactions involving in the aggregate $10,000 or less during the calendar quarter." So, mutual funds are specifically by your language, not ours, excluded.

Mr. LUDWIG. I do not believe that is the case.

Mr. DINGELL. Well it is your regulation. Do you want to go home and change it or do you want to read me something that tells me they are not excluded?

Mr. LUDWIG. Every person who sells a mutual fund is covered as a fiduciary under Part 9, and they simply cannot breach their fiduciary responsibilities.

Mr. DINGELL. Well, now, let me ask you a different question. It also says all transactions which in aggregate are less than $10,000 during the quarter. Now, a lot of people will have mutual funds transactions which will be less than $10,000. Are they excluded? Does a little guy who runs in and buys $2,500 worth of mutual funds every quarter, is he covered by that regulation or is he not?

Ms. BROADMAN. Just, as a point of clarification——

Mr. DINGELL. Pardon?

Ms. BROADMAN. As a point of clarification, my understanding of the regulation—I am a little handicapped because I do not have it in front of me—is that it applies to personal trades in the securities that the mutual fund would be buying and selling, because that is how the conflicts come up, or an individual goes out and they buy a particular security, then they recommend to the mutual fund that the mutual fund purchase that security in order to enhance their investment. That is our understanding of frontrunning.

Mr. DINGELL. Well, he could——

Ms. BROADMAN. So, it would involve large transactions in the security of over $10,000, but the mutual fund exception would not apply to his purchase of the underlying securities.

Mr. DINGELL. Well, there is a credit here to the bank. Do they have to report it to the bank? Do they have to report it to the comptroller? Do they have to report it to the SEC? Do they have to report it to the other bank regulators?

Mr. LUDWIG. One thing is worth making a distinction here?

Mr. DINGELL. Pardon?

Mr. LUDWIG. One thing is worth making a distinction here, sir. That is that, in terms of the bank officer's sale of mutual fund shares to individuals, that is covered by Part 9, in terms of his conflict of interest and responsibilities, irrespective of the amount. These provisions deal expressly with the employee's own self-dealing and disclosure and his own trades. That is to say, when an employee is selling investment products to individuals, the Part 9 provisions apply, irrespective of amount.

Ms. BROADMAN. Let me also answer your question in terms of——

Mr. DINGELL. Does Part 9—I am sorry, go ahead.

Ms. BROADMAN. The disclosure obligations under Part 12 are to the bank. The employee has to disclose the information to the bank.

Mr. DINGELL. OK. He does not have to——

Ms. BROADMAN. When our examiners go in and examine the bank, those are the records that they would look at in order to identify abusive practices.

Mr. DINGELL. What about the SEC? He has not a responsibility to disclose these matters to the SEC?

Mr. LUDWIG. He might if he were an employee of a subsidiary of the bank.

Mr. DINGELL. That is only if the subsidiary is registered with the SEC, isn't that right?

Ms. BROADMAN. That is correct.

Mr. LUDWIG. That is correct.

Mr. DINGELL. Now, does the SEC have any power to go in and to look at these statements of conflict of interest on the part of the employee?

Mr. LUDWIG. They certainly do in the case of a registered subsidiary.

Mr. DINGELL. If it is registered with the SEC, they do; is that right?

Mr. LUDWIG. That is correct.

Mr. DINGELL. If it is not registered with SEC, do they?

Ms. BROADMAN. My understanding is they do not because the individual would be subject to our jurisdiction, and we would be the Agency that would take an action against that individual for breach of fiduciary duty.

Mr. DINGELL. Well, what you are telling me is, if they are not registered with the SEC they cannot go in and look, the SEC does not get this information, do they?

Ms. BROADMAN. Well, we have been——

Mr. DINGELL. Now, this individual is marketing a security which is regulated by the SEC, but they cannot go in and find out who is sheltered by this exclusion which you have in place in your regulations. The SEC has no way of going in and finding out whether this is going on.

Mr. LUDWIG. We, in fact, make referrals to the——

Mr. DINGELL. Pardon?

Mr. LUDWIG. We, in fact, make referrals to the SEC, and——

Mr. DINGELL. Do you make referrals in all cases?

Mr. LUDWIG. In terms——

Mr. DINGELL. Do you routinely make referrals in all cases where you find this going on?

Mr. LUDWIG. I cannot give you an answer to that question.

Mr. DINGELL. As a matter of fact, can you tell me you do?

Mr. LUDWIG. Well, let me say, sir, since I have taken office, we have developed a cooperative working relationship——

Mr. DINGELL. Friend, would you just humor me and answer my question? Have you ever referred any of these matters to the SEC?

Mr. LUDWIG. I will have to get back to you on that question.

Mr. DINGELL. In other words, you are unaware of any instance in which you have referred these matters to the SEC?/

Mr. LUDWIG. I know we have engaged in a reasonable amount of cooperative activity in which we have referred a number of matters to the SEC. I cannot be certain of——

Mr. DINGELL. What is a "reasonable amount of cooperative activity"? Does that constitute drawing up a memorandum of understanding to have an agreement with the SEC that you will refer all matters of this sort to the SEC so that they can find out whether somebody is frontrunning and engaging in a conflict of interest or some practice of that sort? How about on insider trading? Do you have any requirements with regard to reporting to the SEC? Does the SEC have any authority to go in and to inquire of a bank employee who might make this report to his superior?

Mr. LUDWIG. Where there are the fraud provisions involved, the SEC has jurisdiction.

Mr. DINGELL. The SEC has jurisdiction in fraud only.

Mr. LUDWIG. Moreover, let me say we have a number of investigations currently underway with the SEC.

Mr. DINGELL. Now, how does the SEC know whether there is fraud if the matter is not reported to them—if you do not report it to the SEC? Let's take the well-known case of Dennis Levine—insider trading. Let's say Dennis Levine had been an employee of a bank instead of having been an employee of a broker-dealer. The bank would have had no authority and no requirement to refer this to the SEC. You have told us you have not any awareness of any instance in which that matter had been referred to the SEC either by your Agency or by the bank.

Mr. LUDWIG. My staff may be aware of it. In fact, we have——

Mr. DINGELL. My question to you is——

Mr. LUDWIG [continuing]. Referred cases to the SEC of this type, and we will provide that information.

Mr. DINGELL [continuing]. Given that circumstance, how would Dennis Levine have ever been caught in what became one of the largest scandals in the American history of securities—the Dennis Levine-Boesky-Milken scandal?

Mr. LUDWIG. Well——

Mr. DINGELL. That behavior would have been sheltered beautifully behind your regulation.

Mr. LUDWIG. Well, sir, we have a different supervisory mechanism than the SEC, but we have a very active supervisory mechanism, in which we have literally thousands of supervisors. We take our responsibilities very seriously, in terms of using the resources of the Federal Government——

Mr. DINGELL. Beloved friend, I am not asking you about the wonderful sincerity of all of these good-hearted bankers and employees of yours. I am asking you about rascals who want to screw the public or screw some unfortunate investor. I am dealing with a very particular instance which could be very very large, because it could involve not just taking the widow Goodbody to the cleaners, but it might involve the manipulation of the markets and the whole structure of the financial integrity of the financial markets in this country. I am just asking you do you have any routine way of transferring this information to the SEC? Have you transferred this information? Do you have any rules or regulations requiring that? Does it get transferred to you? How do you know that under this regulation the banks are going to in fact receive the information or make it available to you and what coordination do you have to deal with the SEC?

Ms. BROADMAN. We have a policy of referring to the SEC potential violations of law that we find that are within their jurisdiction. That policy is reflected in a policy statement which we will be happy to submit for the record. In addition, we have made referrals to the SEC where we have found insider trading.

Mr. DINGELL. Well, I am delighted to hear that. Now, in how many instances have you made such referrals to the SEC?

Ms. BROADMAN. I do not have the numbers.

Mr. DINGELL. Have you ever done it?

Mr. LUDWIG. Yes.
Ms. BROADMAN. Yes.
Mr. DINGELL. You have?
Mr. LUDWIG. Yes.
Mr. DINGELL. When did you do it?
Mr. LUDWIG. We will provide that for the record.
Mr. DINGELL. Would you submit to us all instances in which that has been done?
Mr. LUDWIG. Absolutely.
Mr. DINGELL. Well, the Chair has got to adjourn the hearing briefly because we have a vote on the journal to which I must go. I will return here in approximately 15 minutes. So, we will reconvene then at 25 minutes after. The committee stands in recess until that time.
[Brief recess.]
Mr. DINGELL. The subcommittee will come to order. Mr. Ludwig, welcome back.

When you met with the staff of the committee last week, you were asked if you could cite an instance in which the Comptroller or the Comptroller's Office had taken action against banks for misbehavior with regard to the sales of securities. You told the staff at that time that you could recall no instance of that or were unaware of any and that you were going to inquire into that matter to find out whether such action had been taken. Can you tell me if you have inquired and, if so, what your findings on that matter might be?

Mr. LUDWIG. Well, I think, as we mentioned earlier, we have taken action in some securities cases.

Mr. DINGELL. Would you tell us, please, what those cases might be?

Mr. LUDWIG. As I said earlier, I would be pleased to submit the answer to that question for the record.

Mr. DINGELL. Now, do these matters relate to investor protection?

Mr. LUDWIG. Yes.

Mr. DINGELL. Now, when you say bank mutual fund operations must incorporate protections and safeguards, what you are really stating is that they do not exist today, is that right?

Mr. LUDWIG. Pardon me, sir? I did not hear you.

Mr. DINGELL. When you say bank mutual fund operations must incorporate protections and safeguards, what you are really saying is they do not exist today, is that right?

Mr. LUDWIG. I do not understand what you mean.

Mr. DINGELL. You made a lengthy comment in your statement. You said "the rapid growth of banks' sales of mutual funds must also raise a number of serious policy issues that regulators and the banking industry need to address. Mutual fund operations must incorporate adequate consumer protections and safeguards against potential conflicts of interest."

Now, when you say "bank mutual funds must incorporate," what you are really saying is they do not exist today, isn't that so?

Mr. LUDWIG. No, sir. I would not go that far. That is to say, clearly, our guidance, BC-274, has been out since July, and we

know that a number of banks do in fact have significant disclosures, and they advise their customers——

Mr. DINGELL. I am not talking about what the banks do. Your mandates to the bank at this time are essentially voluntary, as you have said.

Mr. LUDWIG. Oh, they are not——

Mr. DINGELL. What I am asking you is what are your rules and regulations which are mandatory in character, and what are your statutory powers to address these matters? I am thinking that what you are telling me is that, neither in your own regulations, nor in the practices of most banks, nor in your basic statutes do those protections to which you referred in your statement exist.

Mr. LUDWIG. No, sir. Perhaps I have not been clear. The guidance which we issued last July is enforceable by us, and we expect it to be followed.

Mr. DINGELL. This is what we are trying to find out.

Mr. LUDWIG. Pardon me?

Mr. DINGELL. Let me ask you about protections against things like frontrunning, insider trading and self-dealing. You say they exist in Part 12?

Mr. LUDWIG. In terms of frontrunning and insider trading, we refer to these as Part 12 and Part 9.

Mr. DINGELL. We read that language (Part 12) and we do not find it. Then you say that they exist in Part 9. We read those provisions and we do not find them again. I am trying to understand what you are reading there that I am reading that is different, or what I am not reading that I should be reading. Can you cite the specific language of those sections?

Maybe Ms. Broadman can do that for us. Having a discussion without having the language before us is very difficult. Now, Ms. Broadman, you have a copy of the language. Will you read the specific language that affords the Office of the Comptroller of the Currency these powers to protect investors?

Ms. BROADMAN. OK. I think the first statute you need to look at is 12 USC section 1818, which gives us authority to bring actions against banks that engage in unsafe and——

Mr. DINGELL. That gives you authority to do what?

Ms. BROADMAN. It gives us authority to bring actions against banks that engage in unsafe and unsound banking practices. We would view noncompliance with our interagency statement, for example——

Mr. DINGELL. Beloved friend——

Ms. BROADMAN [continuing]. The recommendation of unsuitable trades.

Mr. DINGELL. Let's just analyze that. It says unsafe banking practices. It does not say securities, does it?

Mr. LUDWIG. We would view this practice as——

Mr. DINGELL. Pardon?

Mr. LUDWIG. We would view these securities practices as a banking practice.

Mr. DINGELL. How do you do that?

Ms. BROADMAN. For example, let's say a bank was to recommend unsuitable investments to a customer. That is something that would be contrary to our interagency statement.

Mr. DINGELL. It would be contrary to what?

Ms. BROADMAN. To the interagency statement.

Mr. DINGELL. To the interagency statement?

Ms. BROADMAN. That is correct. Our interagency statement——

Mr. DINGELL. The interagency statement is a list of voluntary practices, is it not?

Ms. BROADMAN. I am trying to explain why these would constitute unsafe and unsound——

Mr. DINGELL. No, no, no, beloved friend. I am trying to work with you as we do this together.

Ms. BROADMAN. OK. It is not a voluntary statement. Compliance with the interagency guidelines is not a matter of voluntary action. Failure to comply with our interagency statement, in our view, could constitute an unsafe or unsound banking practice, for which we could bring——

Mr. DINGELL. Let's read your language then. We are talking about suitability in sales practices, that is paragraph number 4 at page 12. It says: "Depository institution personnel involved in the selling of nondeposit investment products must adhere to fair and reasonable sales practices . . ."——

Mr. LUDWIG. Mr. Chairman, perhaps I could answer this question for you.

Mr. DINGELL. Pardon?

Mr. LUDWIG. Perhaps I could answer this question for you.

Mr. DINGELL. Well, before you do, may I ask—"...and be subject to effective management and compliance reviews with regard to such practices."

Now, what are the "fair and reasonable sales practices," and how are they defined, and on what—on what power that you have to deal with these questions is that bottomed?

Mr. LUDWIG. Perhaps I can deal with this. Our supervisory mechanism is a mechanism that involves a large number of people in banks on a continual basis. They are in the largest banks in this country every business day of the week. They are actually resident. In terms of these guidelines, the reason we issued statements and guidelines——

Mr. DINGELL. This large number of people you have got in there, those are examiners, aren't they?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. OK. Now, are these securities specialists?

Mr. LUDWIG. Our examiners are trained to—and that is why these examination guidelines are so important——

Mr. DINGELL. Are these——

Mr. LUDWIG [continuing]. Carry out those guidelines in particular.

Mr. DINGELL. Where are the rules and regulations under which those examiners will function with regard to assuring the "fair and reasonable sales practices" and that they are subject to effective management and compliance reviews? This is a general statement. Where are there clear instructions?

Mr. LUDWIG. Let me explain why we used guidelines originally. And your question about regulations is well-taken.

Mr. DINGELL. We have a fairly limited amount of time. I would really appreciate it if you would respond to my questions, because

it would help both of get out of here earlier. Now, here is the NASD manual. Are you familiar with this document?

Mr. LUDWIG. I certainly am. We have, in essence, incorporated the NASD suitability——

Mr. DINGELL. Do you have anything like an NASD manual with regard to the behavior of broker dealers or sellers of securities, or with regard to their responsibilities, with regard to frontrunning, suitability, insider trading?

Mr. LUDWIG. If you are asking have we integrated, by regulation, the NASD guidelines, we do not have a regulation——

Mr. DINGELL. The answer is you do not?

Mr. LUDWIG [continuing]. That does that.

Mr. DINGELL. Do you have any——

Mr. LUDWIG. However, we have incorporated the NASD standards, by reference, in the guidelines, so that the banks have——

Mr. DINGELL. You are telling me that you incorporate by reference the NASD manual?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Where do you do that?

Mr. LUDWIG. In our guidelines——

Mr. DINGELL. Where?

Mr. LUDWIG. In terms of the suitability standards, that is, in BC-274.

Mr. DINGELL. Read me the language.

Mr. LUDWIG. OK. The suitability—"consistent with the rules..."——

Mr. DINGELL. What page?

Mr. LUDWIG. Page 8.

Mr. DINGELL. Page 8.

Mr. LUDWIG. Of the exam guidelines, section 4(13)(1), under suitability.

Mr. DINGELL. From where are you reading here, please, sir?

Mr. LUDWIG. These are exam guidelines.

Mr. DINGELL. You have been referring to the interagency statement, have you not? Where is it in the interagency statement?

Mr. LUDWIG. The reference to suitability is here and not in the interagency statement. I was corrected.

Mr. DINGELL. The statement applies to the bank, does it not?

Mr. LUDWIG. Pardon me?

Mr. DINGELL. The statement applies to the bank, does it not?

Mr. LUDWIG. Excuse me, sir?

Mr. DINGELL. The statement—this interagency statement that we are addressing applies to the bank?

Mr. LUDWIG. Yes, it does.

Mr. DINGELL. Now, where is the NASD manual incorporated in that?

Mr. LUDWIG. In our BC-274, which was the basis for the interagency guidelines, which we provided to all of the banks, we included the cross-reference to the NASD rules explicitly.

Mr. DINGELL. Read that to me would you please?

Mr. LUDWIG. Could we have a copy of BC-274? We could submit that for the record. Let me see if we have a copy. If not, we certainly will submit it for the record. It was incorporated again in our examination guidelines, which I can read you.

Mr. DINGELL. Now, wait, that is for the examiners, that is not for the bank, though.

Mr. LUDWIG. Let me say, sir, your point about——

Mr. DINGELL. Beloved friend, we must talk about apples and apples, and oranges and oranges, but not apples and oranges. We cannot move back and forth. This is an instruction here to your examiner, and it does not give force and effect to this.

Mr. LUDWIG. Let me read BC-274. We did bring it along. Under minimum standards it says: "The rules of fair practice of the National Association of Securities Dealers expressly govern sales of securities by broker-dealers who are members of the NASD. These rules apply to bank-related securities sales by banking subsidiaries registered as broker-dealers affiliated..."——

Mr. DINGELL. Now, wait. That is by bank subsidiaries registered as broker-dealers.

Mr. LUDWIG. Now, I am not finished.

Mr. DINGELL. How about all of the other banks who are not so registered?

Mr. LUDWIG. I am not finished—"...and unaffiliated broker-dealers operating under agreements with banks. These rules apply whether such sales are made on bank premises or at separate locations. Even for bank-related sales where such rules do not expressly apply, the rules of fair practice are an appropriate reference in constructing a compliance program..."——

Mr. DINGELL. Wait. Wait. "An appropriate reference." It does not say "will be complied with" by the persons and the class of persons to whom you have just referred.

Mr. LUDWIG. Well, the way our examiners would—and that is why it is in the examination guidelines——

Mr. DINGELL. We are not talking about your examiners; we are talking about the banks. What requirements are imposed on the banks by your rules and regulations? You have told us of none.

Mr. LUDWIG. It is to have a compliance program for safe and sound retail sales of nondeposit instruments. In constructing that program, they are to make specific reference to NASD.

Mr. DINGELL. Beloved friend, where are these made mandatory on banks and bank employees who are not regulated by the NASD or the SEC?

Mr. LUDWIG. Those rules are not made absolutely expressly mandatory. We will be examining them on that basis.

Mr. DINGELL. What does that mean? They are "not made absolutely expressly mandatory." Does that mean that they are sort of applied, or not applied, or sort of not applied? If they are sort of applied or sort of not applied, in which instance are they sort of applied or sort of not applied? They either are applied or they are not applied. Now, address that, please?

Mr. LUDWIG. No, I do not think so, sir. That is to say, we have given banks some flexibility here to develop their own programs with reference to the NASD.

Mr. DINGELL. You have given "some flexibility." Now, flexibility means they can apply these or not apply them, does it not?

Mr. LUDWIG. They have to have equivalent programs.

Mr. DINGELL. Where is that said in your rules and regulations?

Mr. LUDWIG. Well, let me see if we can find that one.

Ms. BROADMAN. The bottom line here is that banks have to——

Mr. DINGELL. Beloved friend, please let Mr. Ludwig answer that question.

Mr. LUDWIG. Even for bank-related sales where such rules do not expressly apply, the rules of fair practice are an appropriate reference in constructing a compliance program for safe and sound retail sales of all nondeposit investment products.

Mr. DINGELL. They do not expressly apply.

Mr. LUDWIG. They have to have a compliance program for the safe and sound——

Mr. DINGELL. What test must the compliance program meet?

Mr. LUDWIG. We are cross-referencing——

Mr. DINGELL. Obviously they are going to meet some test when the compliance program goes into place. What test are they going to meet, and what kind of behavior is going to meet the requirement that you are laying in place here?

Mr. LUDWIG. Well, we are insisting that banks have a compliance program for the safe and sound retail sale——

Mr. DINGELL. All right. What is "a compliance program"?

Mr. LUDWIG. Pardon me?

Mr. DINGELL. What is "a compliance program," and with what is that compliance program to comply or to compel the bank to comply?

Mr. LUDWIG. As I mentioned, in some cases, we expressly require that the NASD rules are met——

Mr. DINGELL. In some cases, you expressly require what?

Mr. LUDWIG. That the NASD rules be met.

Mr. DINGELL. All right. Now, in what cases——

Mr. LUDWIG. In these cases, we incorporate——

Mr. DINGELL. In what cases do you expressly require the NASD rules to apply?

Mr. LUDWIG. Where we have either agreements with banks——

Mr. DINGELL. Where you have an agreement with a bank?

Mr. LUDWIG. Yes.

Mr. DINGELL. In other words, you go hat in hand to the president of the bank and say, dear, Mr. President, would you put these rules in place?

Mr. LUDWIG. When banks apply to us, as is the case of Mellon-Dreyfus, in the Mellon-Dreyfus situation——

Mr. DINGELL. Are you going to require full compliance with the NASD rules for Mellon-Dreyfus?

Mr. LUDWIG. As I mentioned to your staff, we will be including——

Mr. DINGELL. OK.

Mr. LUDWIG [continuing]. If we decide to go forward with the approval, a variety of commitments and conditions.

Mr. DINGELL. Well, I assume you can——

Mr. LUDWIG. In fact, in this situation, where there is a broker-dealer, I would think we would not even have to have a condition for the NASD rules to apply.

Mr. DINGELL. All right. So, you are very comfortable in having this applied to Dreyfus, because they are a registered broker-dealer. What about the other people in the bank who are going to be

selling these mutual funds? To what criteria are you going to compel them to adhere?

Mr. LUDWIG. We are going to be looking at bank suitability programs very carefully. If we find that we have to do by regulation what we are not now doing by guidance, in order to make sure that they are suitable, we will do so.

Mr. DINGELL. Now, banks are selling securities now. Is there a suitability program in place now in all banks?

Mr. LUDWIG. We require suitability as a——

Mr. DINGELL. Pardon?

Mr. LUDWIG. We require a suitability of sale in some——

Mr. DINGELL. How many banks actually have a suitability program?

Mr. LUDWIG. I would rather be accurate and submit it for the record. My understanding is that every bank that is selling this product has to have a suitability program or be violating our rules.

Mr. DINGELL. Would you be surprised if they did not?

Mr. LUDWIG. I would be surprised if they did not.

Mr. DINGELL. Have you sent anybody out to check to see whether they do?

Mr. LUDWIG. That is exactly what our examination procedures will be doing.

Mr. DINGELL. Have they done it yet?

Mr. LUDWIG. We have been reviewing banks this year. Since I have been on board, we have reviewed over 300 banks.

Mr. DINGELL. Over 300 out of how many?

Mr. LUDWIG. Out of roughly 3,400.

Mr. DINGELL. Out of 3,400. Can you make the flat bald statement that——

Mr. LUDWIG. That is this year——

Mr. DINGELL. All of the 300 banks that you have reviewed this year have a suitability program in place?

Mr. LUDWIG [continuing]. Over the past 11 months. They would be violating our rules if they do not have a suitability program.

Mr. DINGELL. How many have adopted the NASD Rules of Fair Practice to which we have been addressing ourselves?

Mr. LUDWIG. Those banking organizations——

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG. Those banking organizations where the subsidiary is——

Mr. DINGELL. Have they all done so?

Mr. LUDWIG. Well, those banking organizations where the subsidiary of the broker-dealer——

Mr. DINGELL. All the 300 have done so?

Mr. LUDWIG. Pardon me?

Mr. DINGELL. All 300 that you have examined this year have adopted these—this NASD document as their rules?

Mr. LUDWIG. I will get back to you.

Mr. DINGELL. Either they have or they have not, or you do not know. Which is the answer?

Mr. LUDWIG. I expect that they have.

Mr. DINGELL. Well, wait, wait. Do you know or do you not know? I take certain things on faith. I believe in the Holy Trinity, but I really do not believe in the Office of the Comptroller of the Cur-

rency—yet. What I am trying to do is to have you tell me; you are saying you believe. Believe means that you do not know, but you think; isn't that right?

Mr. LUDWIG. I believe that is correct.

Mr. DINGELL. So, you do not know how many banks have in fact adopted all or parts of the NASD document entitled the Rules of Fair Practice in their manual?

Mr. LUDWIG. Well, I am comfortable that all of our banks are obligated to adopt suitability standards that are either the NASD suitability or equivalent.

Mr. DINGELL. What rules have the banks that have not adopted this?

Mr. LUDWIG. Our examiners examine their suitability requirements, and when they incorporate——

Mr. DINGELL. Your examiners examine for a suitability requirement? Now, how many of them have reported to you that the banks have or do not have the Rules of Fair Practice, as set forth by the NASD, as a part of their rules and regulations? Where do you mandate the banks to do that?

Mr. LUDWIG. Well, there is no case, my staff tells me, where the bank has not agreed to correct suitability problems when we have identified them in exams.

Mr. DINGELL. All right. Now, wait. What about rules requiring them to do that? Or what do these suitability requirements require the banks to do?

Mr. LUDWIG. Well, as I have stated, we expect them to have——

Mr. DINGELL. Dear friend, I did not ask you what you expect. I asked specifically what the banks are doing.

Mr. LUDWIG. They are——

Mr. DINGELL. Now, they are either not——

Mr. LUDWIG. They are either violating our rules or they have suitability standards.

Mr. DINGELL. Well, now, what kind of suitability standard meets your rules?

Mr. LUDWIG. A suitability standard that is equivalent to the NASD, that is, one that is——

Mr. DINGELL. That is equivalent?

Mr. LUDWIG [continuing]. To the fair practice standards.

Mr. DINGELL. What is "equivalent" to the suitability rules set forth in here and what is not equivalent to it?

Mr. LUDWIG. Well, our examination approach deals with these financial institutions very much on a case-by-case basis, examining what they do.

Mr. DINGELL. How do you deal with the suitability of sale of securities to Aunt Minnie Goodbody, who is 75 years old, just lost her husband, and is bringing in the CD which is up for renewal? Now, what is the suitability for that, and how do you define it?

Mr. LUDWIG. Well, I would like to reserve on that question, and respond to it——

Mr. DINGELL. Dear friend, we do not get you before this subcommittee very often. I assumed that you had prepared as carefully for this as I had, so that we would both know what we were talking about. What I am trying to find out is are the banks behaving properly or are the banks not behaving properly? Are you control-

ling the banks properly or are you not controlling the banks properly? So far, I have asked you what you have in the way of suitability rules. Now, here, you have got the NASD rules of suitability, right?

Mr. LUDWIG. That is right.

Mr. DINGELL. You say that, if they approximately comply with them, that is all right. Now, my question to you is what is approximately all right?

Mr. LUDWIG. In some cases, they may be better.

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG. In some cases, they may be better. I mean——

Mr. DINGELL. Some things may be better and some things may be worse. You are in the unfortunate position of not knowing whether the banks are complying with a better standard of rules or a lesser standard of rules, because you have never told the banks what they have really got to do, have you? You have just said, "banks, go out and get yourselves a set of suitability rules," and the bank hands you a set of suitability rules and says "these are suitability rules"; or your examiner goes in and says "you got suitability rules?", and the banker says, "yes, we have got suitability rules", and your examiner says "why, that is wonderful, congratulations."

Now, amidst this, how do you protect poor old aunt Minnie Goodbody who at 75 is walking in to a bank with a $50,000 CD open for renewal, and it is everything she has got in the world? Now, how do you protect her? What clear guideline do you have to the bank?

Mr. LUDWIG. Well, let me read the guidelines here.

Mr. DINGELL. What clear guideline do you have to the bank.

Mr. LUDWIG. It is explicitly——

Mr. DINGELL. Do you have any?

Mr. LUDWIG [continuing]. Applied to banks. First of all, let me say that we expect all of the banks to have suitability rules that are either equivalent to the NASD or better. It is not a matter of their being approximately worse.

Mr. DINGELL. You do not know what that is, and you do not define that to the bank, do you?

Mr. LUDWIG. We have yet to define it in that level of specificity because of the nature——

Mr. DINGELL. The banks are selling $2 billion worth of mutual funds a week. I guess that is a fairly good sum because the average guy has got $30,000-$40,000 worth of mutual funds, and that is all he has got in the world.

Mr. LUDWIG. Mr. Chairman——

Mr. DINGELL. How, dear friend, are you going to have me understand that you know what these suitability rules are and that these suitability rules protect the average blockhead investor that does not know anything about what he is buying and he goes in and he talks to Mr. Frank B. Sly, his friendly broker and local bank specialist in securities, who is not a registered broker-dealer and who is simply functioning out of an office in the bank? Now, how is poor Aunt Minnie Goodbody going to be protected against Mr. Frank B. Sly under those conditions? What rules and regula-

tions do you have in place which would afford her the protection which she needs?

Mr. LUDWIG. The question is what the institution is doing to protect the individual. They can have all of the rules in the world and, if they are not actually doing it, and they are not actually serious about it——

Mr. DINGELL. You are a highly-intelligent fellow, but will you let me ask the questions? When I appear before you, you ask the questions, and I will give you the answer. Now, please answer my question.

Mr. LUDWIG. Yes. Let me read our exam guideline actually giving a specific example.

Mr. DINGELL. Well, can you just——

Mr. LUDWIG. One example of critical——

Mr. DINGELL [continuing]. Tell me what assurance do you have that all these banks are applying NASD rules or rules which afford equal protection in connection with suitability behavior?

Mr. LUDWIG. We have 3,300 examiners. I have been around the country and met many of these examiners, and we have a high-quality examination——

Mr. DINGELL. Beloved friend, I have not asked you about the quality of your examiners. As far as I am concerned, you can have the College of Cardinals functioning as examiners, and I would still ask you the same question. What assurance do you have that the suitability rules equivalent to this document [waving the NASD Manual] are being applied by the banks? What assurance do you have that your 3,300 good-hearted examiners that are going around and examining all of these good-hearted bankers are assuring that we have equivalent suitability rules to the NASD manual?

Mr. LUDWIG. Let me read this portion of our examination procedures.

Mr. DINGELL. Beloved friend, answer my question.

Mr. LUDWIG. I am sorry.

Mr. DINGELL. Please, answer the question. Did you understand it?

Mr. LUDWIG. Well, I do not imagine that we have any less——

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG [continuing]. Of a level of certainty that these are seriously being applied and taken into consideration than the SEC or anybody else with respect to other providers of these services. I mean, we are following these examination procedures, we will be in and examining seriously, aggressively, in terms of these institutions' suitability, and other requirements, sir.

Mr. DINGELL. You are one of the most trusting people that we have ever had before the subcommittee. I am sure that your sainthood is assured, because you trust everybody. Now, I want you to know that my old daddy taught me to trust everybody, but he also taught me to cut the cards. My question to you is what assurance do you have that these rules are being applied or equivalent rules are being applied by every bank that you have looked at amongst these 300 banks——

Mr. LUDWIG. If the suitability rules——

Mr. DINGELL [continuing]. That are selling securities?

Mr. LUDWIG. Because, if they are not applied, we will take action to see that they are applied.

Mr. DINGELL. So, how are you going to find out that they are not being applied?

Mr. LUDWIG. Our examiners are out there examining to determine whether they are applied.

Mr. DINGELL. Let me go back into something I learned way back when I was learning philosophy and when I was learning law. Good law requires that you give a clear standard of behavior, right? Isn't that right? In other words, you say, this is permitted, this is forbidden, right? It has to be clear. The Constitution even requires it. If we write a criminal statute so vague they do not know what it means, they can be acquitted because the law is unconstitutional.

Now, what does your statute or your regulatory practice require the bankers to do with regard to suitability rules? I want a clear statement of what that requires the banker to do?

Mr. LUDWIG. They must determine suitability. They must ask about tax status, financial status——

Mr. DINGELL. Where is that required?

Mr. LUDWIG [continuing] And investment objectives.

Mr. DINGELL. Where is that in the rule?

Mr. LUDWIG. That is in the NASD rules.

Mr. DINGELL. That is an NASD rule. You have told me that you are requiring something approximately equal to the NASD rules—in some instances superior, and in some instances inferior. I am trying to find out what are the mandates to your examiners, or what are the mandates to your regulated banks?

Mr. LUDWIG. As I mentioned, we cross-reference them.

Mr. DINGELL. Well, there either is a regulation which requires this, or there is a regulation which does not. There is either a regulation which is clear or there is a regulation which is not clear. I am asking you to tell us there is a rule, there is not a rule, there is a regulation which is clear, there is a regulation which is unclear. What you are telling me is that you have at this moment a vast confabulation between your examiners and the bank in the event the examiner asks do you have rules of suitability in place which are equivalent to the NASD manual. Then you have this enormous discussion which takes place.

Mr. LUDWIG. I do not agree with the fact that we have a vast confabulation. I think we supervise pretty well.

Mr. DINGELL. All right. I am a poor, unfortunate banker, and your examiner descends upon me and says "where are your rules of suitability?" I say, "we have got rules of suitability." He says, "good, what are they?" I say, "they are approximately equal to the National Association of Securities Dealers Manual." He says, "oh, that is wonderful. What does that mean?" I say "it means they are approximately equal. It means sometimes they are better, sometimes they are worse." He says, "oh, that is wonderful." Then he comes back to you and says "Dingell just told me this is what they are doing and we think it is wonderful." Are you going to say yes, that is wonderful, or are you going to say that is a lot of hooey? Which are you going to tell me, or which are you going to tell your examiner?

Mr. LUDWIG. Well, I can tell you what we tell the banks.

Mr. DINGELL. Pardon?

Mr. LUDWIG. I can tell you what we tell the banks because I have it in front of me.

Mr. DINGELL. Pardon.

Mr. LUDWIG. Sir, I can tell you what we tell the banks because I have it in front of me. I would expect our examiners to see that this is adhered to.

Mr. DINGELL. The examiner does not have the vaguest idea of what is equal to or approximately similar to the NASD manual which he is supposed to inquire about and as to whether the rules are approximately or equal or roughly similar to or sort of like the rules of the National Association of Securities Dealers, as set forth in the NASD manual. What objective criteria do you give them with regard to specific behavior?

Mr. LUDWIG. That is why we cross-reference the——

Mr. DINGELL. Pardon?

Mr. LUDWIG. That is why we cross-reference the NASD rules in the BC-274, so that they in fact do apply that.

Mr. DINGELL. You have not mandated that they be exactly the same. You say, please consider the NASD rule. You have not say the NASD rules are the rules. You have said sort of consider the NASD rules.

Mr. LUDWIG. We have not done that. Let me say, as I mentioned, we are very serious about this. If we find, sir, that they are not applying the equivalent or better, we might well adopt a more specific standard.

Mr. DINGELL. Mr. Ludwig, you have not been serious enough to give your examiners a clear appreciation of what the rules of suitability are. You say—you tell the bank to refer to the NASD rules, but you do not tell your examiner what are the specific items of behavior in there that are supposed to be applied or what are the specific definitions of behavior that are supposed to be applied in connection with these matters.

Mr. LUDWIG. Well, I——

Mr. DINGELL. Your examiner walks in there fat, dumb and happy, not knowing, accepting. About the only thing under your rules is he can say to me, Banker Dingell, he can say, now, Banker Dingell, have you referred to the NASD rules, and I can say, yes, sir, I have, and he goes out of there just happy as all get out because I have referred to the NASD rules.

Mr. LUDWIG. I think I can answer part of this by reading the interagency statement, at least as to what we do.

Mr. DINGELL. Pardon?

Mr. LUDWIG. At least as to what we require the banks to do or I could submit it for the record. It is section 4, page 12 of the interagency statement.

Mr. DINGELL. Well, read section 4. I would like to hear it. Maybe it solves our problem.

Mr. LUDWIG. "Depository institutions' personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard..."——

Mr. DINGELL. You have—go ahead.

Mr. LUDWIG. OK. "...if depository institution personnel recommend nondeposit investment products to customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer."

Mr. DINGELL. What are "fair and reasonable sales practices"?

Mr. LUDWIG. I——

Mr. DINGELL. In the NASD manual, they are defined in extenso.

Mr. LUDWIG. Yes. Let me just go on just a shade more here, because—"the personnel should make reasonable efforts to obtain information directly from the customer regarding at a minimum the customer's financial and tax status, investment objectives and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically."

Now, the information collected is equivalent and I think it is actually identical to the NASD.

Mr. DINGELL. No, no. You have not said identical anywhere before. You have only said approximately equal to or roughly like, sort of like.

Mr. LUDWIG. This says, at a minimum, what they should collect is the customer's financial and tax status, investment objectives and other information that may be useful. I think that that criteria is essentially identical to the NASD standard.

Mr. DINGELL. Well, you have got 3,400 banks you told us that are out there trying to be roughly equivalent or sort of like or a little bit like or kind of like the suitability practice as set forth in the NASD manual. Why don't you just say adopt the NASD manual? What is wrong with having a banker play by the same rules as everybody else? What is wrong with having a banker play by the same rules that every other banker plays by?

Mr. LUDWIG. Well, I take your comments seriously.

Mr. DINGELL. Pardon?

Mr. LUDWIG. I take your comments seriously.

Mr. DINGELL. I want you to do more than take it seriously. I want you to tell me why you should not.

Mr. LUDWIG. Well——

Mr. DINGELL. You have demonstrated up until this time a sort of a reluctance to do that. You seem to be comfortable with the situation where bankers meet a completely different set of rules with regard to suitability than do people who are licensed broker-dealers, some of whom, or both, are working for the bank. You have got broker-dealers who are working for the bank that are required to comply with the NASD manual. You have got other broker-dealers in the bank who are not.

Mr. LUDWIG. In terms of——

Mr. DINGELL. You have got some banks that may be complying exactly with the requirements of the NASD manual, and you have got others that may be sort of or may be not at all. You have got examiners running around trying to figure out whether this fellow is complying with the NASD manual sort of or just whether he has read it or not or referred to it. There is a difference between reading it and referring to it. I am trying to find out what kind of a curious conglomeration of differing regulatory impacts this has on

bankers, on brokers, and on the buyers of securities from banks. Now, you have got a whole web of quite different rules. One guy could go to jail for doing something and another guy would not. One—Aunt Minnie Goodbody might in New York be suckered and sent to jail, or rather—and the broker would not be—or the fellow who sold the securities would not go to jail. It might happen that it would be different in Kansas or someplace like that, or vice versa. I am trying to find out are you comfortable with all of this diversity of rules that you have set up for your examiners and for the regulators?

Mr. LUDWIG. Well, the floor of suitability standards is equivalent to——

Mr. DINGELL. Pardon?

Mr. LUDWIG. The floor of suitability standards is equivalent to the NASD.

Mr. DINGELL. No, no, no. You said approximately equivalent. That is quite different. The floor is not. Your rules only mandate that they refer to them. That is quite different than saying the NASD rules are the floor and we are going to be better. What is your comment?

Mr. LUDWIG. We are trying to make sure that the banks do at least as well, and particularly when they are——

Mr. DINGELL. Well, you are trying, beloved friend, but you have not shown me in any particular that you are making them do so or that you are giving them clear guidelines or that you are giving clear guidelines in the form of clear rules to either your examiners or to the bank.

Mr. LUDWIG. Well, we believe our rules are clear.

Mr. DINGELL. Pardon?

Mr. LUDWIG. We believe our rules are clear and they are new. I take your point. Obviously, you do not. It is worth a serious act of consideration, there is no doubt about it.

Mr. DINGELL. I am comforted to hear you say it.

The Chair is going to recognize the friend from Colorado.

Mr. SCHAEFER. Thank you, Mr. Chairman. I have searched and searched and cannot find any questions to ask beyond what the chairman has already been able to gleen of these witnesses.

I would yield back my time.

Mr. DINGELL. Now, Mr. Ludwig, yesterday we heard from different people involved in the Lincoln Case. Now, the Lincoln Case was not a bank, it was a savings and loan. They called themselves a bank, but they were not. They were a savings and loan. They all agreed that the single most important aspect to the customer's understanding of the transaction was not the prospectus or what was written on other documents, instead it was what is being told to them by their sales persons. Does your office currently use any testers at any bank to evaluate what sales people are telling potential customers?

Mr. LUDWIG. We are just implementing our examination procedures. We have been the first Federal financial Agency to use testers in the area of discrimination. We are in the process of rolling out——

Mr. DINGELL. You are using testers?

Mr. LUDWIG [continuing]. In discrimination the first agency to use testers is being rolled out this quarter. The issue of using testers or mystery shoppers, is an open question with us. I have not made up my mind.

Mr. DINGELL. You do this on discrimination matters, do you not?

Mr. LUDWIG. Yes. We are rolling out a pilot program to see how effective it is on discrimination matters. That is right.

Mr. DINGELL. That is with regard to—that is with respect to lending and discrimination in connection with lending. Do you do that in connection with security sales?

Mr. LUDWIG. As I said, this is an open question with us. It has not been done. We want to see how effective our examination procedures are; but it is something we are seriously thinking about.

Mr. DINGELL. OK. Now, your examiner—he goes into the bank and he looks at the books, doesn't he?

Mr. LUDWIG. Yes. He talks——

Mr. DINGELL. Does he do anything else?

Mr. LUDWIG. He interviews the personnel involved in bank activities.

Mr. DINGELL. Is he instructed to interview the bank personnel about application of the suitability rules?

Mr. LUDWIG. He would typically discuss in a full scope examination the suitability rules and other bank practices with respect to the sale of securities, yes, sir.

Mr. DINGELL. How do you know that? Do you have any rules mandating him to do so?

Mr. LUDWIG. The examination rules that our examiners follow.

Mr. DINGELL. Now, aren't we failing to learn the lesson that has been demonstrated in many cases and many times, and most recently in the Lincoln case—that the prospectuses and the signs are nice, but that fast-talking salesman are really the people who make the sale?

Mr. LUDWIG. The Lincoln case, in a lot of ways, was different, but the implications you are drawing as to the seriousness of making sure that people do not misrepresent, either in their literature or in their oral presentation, a situation is very very important. Under the exam requirements in the interagency guidelines, the banks are required to state clearly their disclosures in communications with the customers and in written material. We are examining for that. What you say—your implication, sir, that can we determine how the customer is really treated when the customer walks in the door, which is before the fact of examination, without using testers, is a difficult question. It is for that reason that I am considering whether or not testers might make sense.

Mr. DINGELL. You also need very clear rules so that the banker knows what he is supposed to do, don't you?

Mr. LUDWIG. I think in terms of disclosure our rules are clear.

Mr. DINGELL. All right.

Mr. LUDWIG. They must disclose——

Mr. DINGELL. Let's just talk about it in general. You need clear rules so that the banker knows what he is supposed to do, right?

Mr. LUDWIG. I think it is important that the banker does know what he is——

Mr. DINGELL. You need clear rules so that your examiner knows how and on what to examine the banker and the bank's books?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Now, have you ever performed any follow-up surveys on customers who have recently purchased securities, such as mutual funds in banks?

Mr. LUDWIG. We are, in fact, in the process of surveying, both with the SEC and on our own, to determine the amount of customer awareness in this area, including how effective programs are. I am actually very proud of part of this, sir, in that I do not think anybody has ever tested before how effective their rules really are in the area of disclosure. We are trying to be ahead of the curve by figuring out which methods of disclosure are most effective with the customer. So, yes, sir, we are surveying. We are surveying seriously and will continue to do so.

Mr. DINGELL. Well, Mr. Ludwig, I am prepared to give you the accolade of saying you are ahead of any of your predecessors. It is also fair to say that banks are now selling $2 billion worth of mutual funds a week. They are also selling an assortment of other securities too. Now, does that tell me that you are ahead of the curve or that you are behind the curve?

While you are putting all of these protections in place, banks are selling $2 billion worth of mutual funds and other securities every week. Are you ahead or behind the curve?

Mr. LUDWIG. Well, sir, there is clearly a problem here, there is no doubt about it. That is why we are working so aggressively. There is no doubt that there is an area of customer confusion, and an area of customer confusion in the sale of mutual funds by nonbanks as well. The statistics there are also pretty disturbing.

Mr. DINGELL. Well, if it comforts you, we are going to take a little look at them too.

Now, Mr. Ludwig, you have established as the measures of success and failures from the findings of this effort what kind of criteria and what kind of judgments? What have you found in connection with this inquiry that you have made?

Mr. LUDWIG. Well, we have engaged in some focus groups.

Mr. DINGELL. Pardon?

Mr. LUDWIG. We have engaged with the SEC in some focus groups, prior to the rolling out of the joint study. The study is incomplete, so that I really cannot give you a finding at this time.

Mr. DINGELL. Well, what would be an acceptable level of confusion here on the part of the banks, on the part of the—on the part of the purchasers of these securities that you would find to be acceptable?

Mr. LUDWIG. Personally, I obviously want to work to see that there is no confusion. The problem is, in these complex financial transactions, whether it is with banks or it is nonbanks, there is always a level of confusion that is very hard to get rid of.

Mr. DINGELL. What, then, is an acceptable level? One in 10, 1 in 2, 8 in 10? Five percent? What?

Mr. LUDWIG. We are working to get the level of confusion to sort of a de minimis level.

Mr. DINGELL. Well, help me understand what is an acceptable level of confusion. How many people can think, for example, that

a bank-sold mutual fund is guaranteed by the bank? What percentage would you regard as an acceptable level of people who would think that?

Mr. LUDWIG. Well, I certainly do not believe that it is acceptable that people are confused. We are working very hard to make sure that they are not confused.

Mr. DINGELL. Well, what is an acceptable level? Should banks be able to peddle to 20 percent of their customers mutual funds on the assumption that these are insured by the FDIC?

Mr. LUDWIG. As I say, we are working very hard to eliminate confusion.

Mr. DINGELL. Well, what is a number?

Mr. LUDWIG. Well, sir, I mean, it seems to me that it is very difficult to define the acceptable level. I mean, obviously, those of us who care about customer confusion, and I do, want to see zero confusion. But, the reality——

Mr. DINGELL. It ought to be zero, ought it not?

Mr. LUDWIG. Yes, but the reality——

Mr. DINGELL. Is any number higher than zero acceptable to you?

Mr. LUDWIG. Well, in a personal sense, no. But the fact is——

Mr. DINGELL. All right. How about a professional sense?

Mr. LUDWIG. Well, in a professional sense, the fact is, unfortunately, when you deal in the financial arena, some people, regardless of what you do, end up confused. The question——

Mr. DINGELL. Some people wind up profiting by that. Some people wind up sewing that confusion so that they can profit. Now, what is the level of acceptability on that? You have said, personally, you think it ought to be zero, professionally, you think it is a higher number. What is the higher number that you will accept professionally?

Mr. LUDWIG. We have not set any numbers because we genuinely want to work on this problem to have as little confusion as is humanly possible.

Mr. DINGELL. Well, that requires then some rather clear instructions to the banks, doesn't it?

Mr. LUDWIG. That is what we have been working on.

Mr. DINGELL. They have got to know what is acceptable and what is not. It also requires clear instruction to you examiners; isn't that right?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Have you got that now?

Mr. LUDWIG. Well, we have rolled out this 30-plus pages of examiner guidance that are our examiner requirements. What they are supposed to do——

Mr. DINGELL. What are the rules for the banks? NASD does it in a book that is approximately an inch thick. You do it in about one paragraph. Now, the good Lord gave us the 10 commandments on two tablets of stone, but none of us here have that power. They are very clear and very understandable. Now, why is it that NASD has to do this in however heck many pages—I looked for the number of pages and I could not find them—4,270-some pages, and you do it in about two paragraphs?

Mr. LUDWIG. Well, as I said——

Mr. DINGELL. Now, is this because your folks are smarter than that or because the bankers are smarter than the securities dealers, or what is it?

Mr. LUDWIG. Well, we are trying to be certain what really works before we lock anything in stone. I take your point on the NASD rules, and it is something that we want to actively consider, whether or not we are being clear enough. I believe we have been clear.

Mr. DINGELL. Securities law has been in place for 60 years, and they have stopped enormous amounts of fraud. Lots of deserving people have gone to jail. A lot of people have gone out of the business. There have been some huge fines leveled. Investors have been protected. How am I to be comfortable that you can do this in two paragraphs and that you can do it better in two paragraphs for the employees of the banks who are not broker-dealers?

Mr. LUDWIG. Well, as I say, I take your point. That is, we believe—and somebody just gave me our side-by-side comparison, in terms of whether or not we are covering all of the important items in the NASD rules. I take your point, in terms of specificity, and we will actively look at this issue.

Mr. DINGELL. Well, you know, I hope you do not view this just as an intellectual exercise. I mean, we are talking about widows whose life's savings can be dissipated. We are talking about retirees who can lose everything they have got. We are talking about youngsters who can lose their moneys that are saved for a house or a college education. We are talking about the kind of hardship we caw in connection with the Lincoln Savings and Loan. What we are trying to find out is what are you doing to see to it that that is not visited on some poor, unfortunate soul? 17,000 people lost money at Lincoln. People were evicted from their homes. Elderly were forced to move back in with their families, children's education was being halted in midstream, and huge economic hardship was imposed on innocent, trusting people because there were no clear guidelines to how Lincoln was to conduct its business.

Now, the next group of potential victims is probably out there right now receiving sales pitches. They are getting brochures and they are getting ads that are going to cause them to transfer moneys from insured instruments, such as CD's, into uninsured instruments such as mutual funds, without knowing about the risk, or perhaps into derivatives or other things, because you are going to permit banks to sell derivatives and futures, aren't you?

Mr. LUDWIG. Banks are in the derivatives business.

Mr. DINGELL. OK. Those are enormously risky, aren't they?

Mr. LUDWIG. Well, they are very complex instruments that involve risk. There is no financial product that does not involve risk. There is no doubt about it. Derivatives involve risk.

Mr. DINGELL. I do not think there is any—as you say—any instrument which offers the complexity that a derivatives offering does. Futures are pretty bad because, if you look at what goes on in the exchange in Chicago, you will find one in 10 of the ordinary people who goes in there makes money. The rest get skinned.

We have talked about mutual funds. What are you doing about derivatives? What are you doing about futures?

Mr. LUDWIG. Actually, we are the first Federal banking Agency to have detailed guidance in the derivatives area. We have an ac-

tive derivatives task force. We are working with the administration and the other bank regulators on derivatives. It is an area of serious concern. Any emerging market in the financial service area is something that has to be looked at and worked with closely.

Mr. DINGELL. Well, let's look at a specific behavior. A bank puts the FDIC disclaimer in small print or in a footnote. What do you think ought to be done about that?

Mr. LUDWIG. Where we found that, and we are examining to find it, we have required that that be changed.

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG. We have required that that be changed.

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG. We have required that that be changed. Now, let me say——

Mr. DINGELL. It requires them to change?

Mr. LUDWIG. Absolutely.

Mr. DINGELL. Do you have a rule on that?

Mr. LUDWIG. Yes, we do. You must——

Mr. DINGELL. What is the rule?

Mr. LUDWIG. You must, under our interagency rules, have——

Mr. DINGELL. Pardon?

Mr. LUDWIG. You must, under our interagency rules, make conspicuous disclosures of the items——

Mr. DINGELL. Now, is that a rule or a guideline?

Mr. LUDWIG. It is—the reason we use guidelines is because you can get them out faster. If you use regulations, you have to get——

Mr. DINGELL. Beloved friend, tell me what the difference is between a rule and a guideline?

Mr. LUDWIG. Well——

Mr. DINGELL. A rule is mandatory, right?

Mr. LUDWIG. Well, we view our guidelines as mandatory.

Mr. DINGELL. Well, a guideline and a rule—are they the same?

Mr. LUDWIG. Well, we expect the banks who receive our guidelines to comply with that guidance.

Mr. DINGELL. Is that—I am trying to understand—a guideline—if I were to get a dictionary out here, would a guideline be classed as a mandatory behavior or just something a person should consider as he does something?

Mr. LUDWIG. Well——

Mr. DINGELL. Would a rule be considered as being mandatory or simply hortatory?

Mr. LUDWIG. Well, when we give guidance to banks under our system of supervision, the banks comply with that guidance, or they are sanctioned—or they change their behavior, or they are sanctioned.

Mr. DINGELL. Let's read the dictionary. Guideline. This is from the New College American Heritage Dictionary. I assume that is a citable source. "Guideline: A mark used to orient lettering. A statement of policy by a person or group having authority over an activity." Now, do these guidelines carry penalties for failure to comply or do they not?

Mr. LUDWIG. Yes. They carry penalties for failure——

Mr. DINGELL. Do they have a penalty section in them?

Mr. LUDWIG [continuing]. To comply.

Mr. DINGELL. Here is the language. It says: "Supervision by banking agencies." I assume that is page 14. Maybe Ms. Broadman would want to consult with it, because it might be useful to us all. It says: "The failure of a depository institution to establish and observe appropriate policies and procedures consistent with this statement, in connection with sales activities, involving non-deposit investment products, will be subject to criticism and appropriate corrective action."

Now, what is the appropriate corrective action to which they will be subject?

Mr. LUDWIG. If the bank is instructed by our examiners to change their behavior as a result of their not complying with the guidelines, and they do not, they will be sanctioned.

Mr. DINGELL. They will be sanctioned?

Mr. LUDWIG. Absolutely.

Mr. DINGELL. On what authority will they be sanctioned?

Mr. LUDWIG. Under our 1818 authority, because they would not be engaging in a safe and sound practice.

Mr. DINGELL. What specific regulation and what specific penalty will be assessed against them for that kind of behavior?

Mr. LUDWIG. We have a variety of penalties that can be assessed, everything from cease and desist——

Mr. DINGELL. What one will be applied? A rule—a statute which is violated always carries integral to itself a penalty for that misbehavior. I assume that there is a penalty defined for this kind of misbehavior, and I am asking you what it is.

Mr. LUDWIG. Well——

Mr. DINGELL. What will be—what will be there amongst this enormous variety of sanctions that you have that will be applied in this case?

Mr. LUDWIG. It depends on the case.

Mr. DINGELL. Pardon?

Mr. LUDWIG. It depends on the case.

Mr. DINGELL. Well, what——

Mr. LUDWIG. It can——

Mr. DINGELL. Pick a number. Tell us which one it is going to be?

Mr. LUDWIG. Well, you have to look at the individual facts and circumstances before you could decide what to do.

Mr. DINGELL. What rule or what penalty will be imposed?

Mr. LUDWIG. Well, first of all, the nature of our supervision effort is to try to insist that they get it right. The important thing is not whether they are sanctioned. The important thing is whether they get it right for the consumer.

Mr. DINGELL. Are you telling us that you are not going to penalize them then?

Mr. LUDWIG. In appropriate cases, we will penalize them.

Mr. DINGELL. Well, let's look at this ad here. It says alternative investments are now available where you bank. It goes on and talks about alternatives to CD's, wishing to learn about tax advantaged investment. "You will want to visit the Investment Center at Commerce Bank. Their licensed investment executives offer Commerce Bank customers a variety of investment products, including annuities and mutual funds. They can assist you in developing a financial strategy, based on your personal objectives. Best of all,

consultations are free and without obligation. It is easy to get started." Then it goes on and—"speak directly with your investment executives. You may arrange an appointment with them through any bank representative." Then, way down at the bottom, there is a little footnote that says: "Commerce Bank and Trust and Liberty Securities Corporations are providing insurance and securities investments exclusively respectively to customers of Commerce Bank and Trust. Liberty Securities, a registered broker-dealer, member of NASD, is not affiliated with Commerce Bank and Trust. These investment products are not deposits or obligations of Commerce Bank and Trust, and are not insured or guaranteed by FDIC or any Government agency."

Now, this is a small footnote. It is hard for me to read. Does that comply with your idea of good practices?

Mr. LUDWIG. From your description, it is not conspicuous and it would not comply.

Mr. DINGELL. It is on the financial page of a major U.S. newspaper. As a matter of fact, it is running right now. Does that comply with your requirements?

Mr. LUDWIG. Well, let me say that we are, in the coming weeks, going to be very aggressive about reviewing the advertising materials of banking organizations. We are in the process of doing more than merely going out and examining. Although that is very significant, that takes place over a period of time. As I mentioned, over the next year, we will have examined all of our institutions to make sure they are complying.

Mr. DINGELL. This is going on right now. This is running right as we talk.

Mr. LUDWIG. That is why we want to review their advertisements. We intend to be very aggressive about that——

Mr. DINGELL. Are these one of the 300 that you——

Mr. LUDWIG [continuing]. In the coming months.

Mr. DINGELL. Are these one of the 300 that you have reviewed?

Mr. LUDWIG. Well, I must say, I do not know from your description whether or not it is even a national bank. It sounds like it probably is not. I think it is probably not a national bank.

Mr. DINGELL. Let's talk about——

Mr. LUDWIG. It did not say national bank in the title. It has either got to say national bank or have N.A. after it. If it does not, it is not one of our banks.

Mr. DINGELL. All right. Let's talk about Bank One. Here is a brochure that is put out and says "customize your investments with the help of Bank One Securities Corporation." Down at the bottom, they talk about protection insurance. It says here: "Protection Insurance." The inference is that they are protected by SIPC. Securities Investor Protection Corporation, including $100,000 in cash, up to $500,000, then Equitable Casualty and Surety Company, $9.5 million. Total coverage $10 million. This is on an offering which they make in connection with a portfolio. It says "mutual funds, municipal bonds, U.S. Treasuries, Federal Agencies, collateralized mortgage obligations, CMO's, unit investment trusts."

Now, does that seem to you that that is a fair advertisement?

Mr. LUDWIG. Well, I have not looked at the advertisement, but to the extent that the advertisement——

Mr. DINGELL. Get him a copy of that, will you? Does that seem to be a fair impression? SIPC only protects against the failure or the broker-dealer, isn't that right?

Mr. LUDWIG. Yes. Having not——

Mr. DINGELL. It does not protect against the loss of values, does it?

Mr. LUDWIG. Yes. The notion that you can sell these things and pretend that SIPC insurance is equivalent to FDIC is misleading and really is an unacceptable practice.

Mr. DINGELL. Now, you have it before you there. Is that a fair advertisement to poor old Aunt Minnie Goodbody? Is she going to think that she has got $10 million worth of protection for her investment that is offered to her by dear Mr. Frank B. Sly at the Rock Solid Bank or Financial Investments 'R' Us?

Mr. LUDWIG. The company that puts out this advertisement is a member of the NASD. It appears to be a registered broker-dealer. I do not want to comment on this because it is obviously related to a bank, and there are certain Banc One subsidiaries that are national banks. As I said, to the extent that this applies, I would like to study it. I do not like to comment publicly about individual bank matters that may involve enforcement actions. I would be happy to discuss that with you privately or prepare a document to submit to the committee. I am loathe to discuss an individual bank matter. Just glancing at this advertisement, I would say that where a bank or anybody else implies that SIPC insurance is the equivalent of FDIC insurance is simply wrong. I mean, that simply is wrong. It should not be done. It is not the same kind of insurance. It does not provide nearly the same kind of protections as FDIC insurance.

Mr. DINGELL. All right. Let's do a little bit of inquiry here. Now, let's take a bank purchasing—owning and operating a mutual fund business. You have stated that the disclosure and disclaimer requirements go beyond the norm; is that correct?

Mr. LUDWIG. I have stated—I have given examples of our disclosure and disclaimer requirements.

Mr. DINGELL. All right. Hypothetically speaking, if the Mellon-Dreyfus merger had already been approved, and was now an operating entity, it goes without saying that Dreyfus mutual funds and the Mellon Bank would have to have all of the appropriate disclaimers associated with it; is that correct?

Mr. LUDWIG. I am just trying to make sure I understand your hypothetical. The Dreyfus Mutual Fund, were it a subsidiary of Mellon Bank, would be a broker-dealer, and it would be subject to our rules, as well as the SEC's rules, and it would be a member of the NASD.

Mr. DINGELL. I am not sure whether I know whether you are saying yes or no.

Mr. LUDWIG. If you are——

Mr. DINGELL. Let me read the question again.

Mr. LUDWIG. If your question is whether or not the—I am just trying to understand—whether or not the securities sold by Dreyfus, as a subsidiary, would have to include the same kind of disclosure that we require for sales of bank proprietary mutual funds or, put differently, whether we would apply the interagency guidance

to Dreyfus, the answer is that it is something under review. It may or may not be a condition of the——

Mr. DINGELL. Aren't we saying——

Mr. LUDWIG. We do not want to discuss the individual application. I mean, I have got to decide it, and it is certainly one of the issues. I mean, I think it is going to be one of the issues they raise.

Mr. DINGELL. Aren't you telling me then that Dreyfus mutual funds sold in the Mellon Bank would have to have all the appropriate disclaimers associated with them?

Mr. LUDWIG. I think that is right. Yes.

Mr. DINGELL. All right. It is also true that, based on media coverage, people across the country would be aware that Dreyfus is now part of the Mellon Bank, isn't that so?

Mr. LUDWIG. Well, those sophisticated investors, who review that, would conclude that Dreyfus is part of the Mellon Bank, that is right, of course.

Mr. DINGELL. Well, in such situations, wouldn't you then be compelled to require that all Dreyfus Advertisements, brochures, and the practice of cold calls contain the necessary disclosures to separate the subsidiary from the bank?

Mr. LUDWIG. As I said, that is clearly an issue before us. We take it very seriously. It is one of the kinds of issues we are dealing with. I cannot publicly discuss how we might come out on an individual application.

Mr. DINGELL. Well, let's say a fellow from Dreyfus Mutual Fund is calling dear old Aunt Minnie Goodbody in Maybe, Michigan, and let's assume that Aunt Minnie has read the Wall Street Journal or the local press or somebody who said that Dreyfus is now part of the Mellon Bank, isn't there going to be confusion over FDIC insurance and whether or not the bank will follow and that the funds of the individual, Aunt Minnie are going to be protected by FDIC? Is there a strong possibility of that?

Mr. LUDWIG. Certainly, that confusion is certainly one of the reasons you would consider applying these same disclosure standards to the subsidiary. It is something that we are considering, but I do not want to discuss the application further.

At the same time, and it is fair to note that that kind of—and it really depends how they operate the subsidiary—that kind of confusion does not necessarily arise from ordinary day-to-day operations if they are entirely separate. It is a complex question. We are very sympathetic to the concern that people may be confused merely by the fact that there is a corporate linkage here. We are looking at the question very closely.

Mr. DINGELL. What you are saying is that it is your duty to protect the consumer or the investor that requires that you take steps to see to it that that confusion exists, as you said, in your personal view, at a level of zero or at least some very low level; isn't that right?

Mr. LUDWIG. It means that we have to be very very cautious in terms of trying to protect the consumer and apply appropriate standards.

Mr. DINGELL. Now, the consumer groups that appeared before the subcommittee yesterday described three types of banks operating out there: Those that are going beyond the guidelines, trying

to find the cutting edge towards educating their consumers; the second group that is complying with the guidelines, but not going beyond it; and a third group that have been referred to as bottom-feeders, who are not complying with the guidelines and appear to treat their customers accordingly. You would agree that their—do you agree that there is a spectrum of bank activity out there which runs from highly-ethical to substantially less ethical?

Mr. LUDWIG. I would hope that there is nobody out there that is a national bank that is substantially less than ethical.

Mr. DINGELL. You would hope?

Mr. LUDWIG. That is exactly why we are examining. That is why we do not leave it just to trust. That is why we have these examination guidelines and have done all of these things this year is in order that we will, in fact, be out on the street examining to make sure that, if there are bottom feeders, that they are dealt with seriously.

Mr. DINGELL. Well, it is fair to say that we are not there yet. You would want this committee to believe that your office is aggressively attempting to determine the solutions to consumer protection problems?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Now, in reality, is it fair to say we are in a state of transition, attempting to find what constitutes adequate disclosure and adequate protection of investors and to implement them?

Mr. LUDWIG. We are, as I mentioned, aggressively going forward with our new guidelines and examination procedures. It is fair to say, given the studies, that investors who buy mutual funds from banks and nonbanks are confused. The studies are not perfect. That is why we are doing an in-depth study with the SEC. Based on what we have seen so far, one would think that investors from a considerable number of mutual fund sellers, whether they are banks or nonbanks, are confused.

Mr. DINGELL. Are you prepared to say that we have figured out all of the answers to what needs to be done to protect consumers or that all of the banks are aggressively attempting to solve the problem or to comply with regulations that they understand which have come forth from the Office of the Comptroller?

Mr. LUDWIG. I would think, honestly, we have moved a long way. We have still got some way to go. In some ways, there is always going to be some way to go. This is a hard area.

Mr. DINGELL. Can you tell me whether we ought to permit banks which do not engage in proper practices with regard to consumer protection or compliance with the NASD manual or your regulations should be permitted to continue selling?

Mr. LUDWIG. This is a very hard area. There are benefits to banks being in the mutual fund business, as I mentioned earlier in answer to a question. At the same time, we have got to make sure that consumers are protected and proper consumer disclosures are made. When a bank intentionally violates our guidelines and when we are not convinced that, after proper examination they are not taking this seriously, we would take very serious steps in those cases. We do not intend to sit back passively and have institutions ignore our guidelines, because we do care about these consumer protections. It is essential that they take this seriously, like their

other safety and soundness responsibilities and consumer responsibilities.

Mr. DINGELL. Now, Mr. Ludwig, your charter, which goes back a long time, charges you with the paramount responsibility of assuring the safety and soundness of banks; is that right?

Mr. LUDWIG. We are certainly responsible for the safety and soundness of national banks.

Mr. DINGELL. Now, Chairman Levitt, of the SEC, testified yesterday that that is what separates you from the SEC, where investor protection is paramount. Can you state unequivocally that when the interest of the banks diverge from the interest of investors, that you would side with investors like the SEC does?

Mr. LUDWIG. Well, I do not think it is a matter of taking sides, sir. I honestly do not. I think that a bank that fails to treat its customers appropriately is committing an unsafe and unsound practice. That is a very serious responsibility on the part of the banks.

Mr. DINGELL. Well, let's look. Banks have capital requirements, do they not?

Mr. LUDWIG. Yes.

Mr. DINGELL. And broker-dealers have capital requirements, do they not?

Mr. LUDWIG. They do.

Mr. DINGELL. Now, let's assume that, in the case of Mellon-Dreyfus, as you have told us—that the capital of the bank is going to be made larger and more secure by the inclusion of the capital of Dreyfus in Mellon Bank.

Mr. LUDWIG. As I said, capitalization of the banking entity is one of the things we would look at, in terms of deciding whether or not to approve or deny the application.

Mr. DINGELL. OK. Now, SEC has got requirements with regard to capitalization of the broker-dealer, do they not?

Mr. LUDWIG. They do. The net capital rules.

Mr. DINGELL. Now, you are going to be dealing with the capitalization requirements. So, if capital is moved from the broker-dealer to the bank, the bank is more secure. That makes you happy, doesn't it?

Mr. LUDWIG. We view it as a consolidated entity. Let me say that the subsidiary must comply with the net capital rules, or we would view it in violation of our own rules. It must comply with all applicable laws, including the net capital requirements at the subsidiary level.

Mr. DINGELL. Well, under what circumstances will you permit the bank to draw capital from the broker-dealer to the bank to add to the stability and the substance of the bank?

Mr. LUDWIG. We, as I said, will require them to comply with applicable law, including the net capital rules. They simply cannot fail comply without violating the law.

Mr. DINGELL. All right. Now, what rules and regulations do you have on this?

Mr. LUDWIG. I guess I have mentioned our 12 USC 1818 authority. They are explicitly required——

Mr. DINGELL. Let's go back.

Mr. LUDWIG. There is a requirement that they comply with law.

Mr. DINGELL. What are your rules which deal with the taking of capital out of the broker-dealer and putting it into the bank? Do you have any clear rules which are written down which say you can take capital out of the broker-dealer at a certain time?

Mr. LUDWIG. Well, as I said——

Mr. DINGELL. You do not—I beg your pardon?

Mr. LUDWIG. Section 1818 requires them to comply with law. They have net capital——

Mr. DINGELL. Well, 1818 is your cease and desist authority, isn't it?

Mr. LUDWIG. Section 1818 is our overall statutory authority for enforcement.

Mr. DINGELL. It does not—but, 1818 does not deal with capital does it?

Mr. LUDWIG. It explicitly requires that institutions comply with laws that are applicable to them.

Mr. DINGELL. Where is the law on this?

Mr. LUDWIG. It is the net capital rules, in terms of the capitalization requirements of the subsidiary. In addition——

Mr. DINGELL. What are your regulations that say that a bank may withdraw capital from a broker-dealer?

Mr. LUDWIG. We expect banks and their affiliates to be operated in a safe and sound manner.

Mr. DINGELL. Beloved friend, you are describing expectations. I am describing rules. I am saying where is the statutory authority or where is your rule which relates to this?

Mr. LUDWIG. Well, our capital adequacy requirements are set forth in detail.

Mr. DINGELL. Capital adequacy requirements relate to banks, do they not? Do they relate to broker-dealers who are subsidiaries?

Mr. LUDWIG. The actual capital adequacy requirements relate to the entire banking enterprise, including its subsidiaries. Actually, the bank capital requirements, the leverage requirements, which are more stringent than the net capital rules, would apply to the subsidiary as well as the bank.

Mr. DINGELL. Mr. Ludwig, that is a wonderful answer, but it was not to the question. Now, I would really appreciate it if you would tell us what are the specific rules which relate to movement of capital from the broker-dealer to the bank. You must have a rule on this, or maybe you do not. I will accept you telling me you do not have a rule on it or that you do not know what the rule is.

Mr. LUDWIG. No, we do——

Mr. DINGELL. Please answer the question.

Mr. LUDWIG. We do have a rule, and the rule is that they have to comply with law, the 1818 rule, and that incorporates their SEC requirements.

Mr. DINGELL. 1818 is an enforcement rule. That is your cease and desist authority. Where is the rule which permits you to address or which dictates how the bank will deal with the movement of capital from the broker-dealer to the bank?

Mr. LUDWIG. Well, the broker-dealer will be subject to all the SEC requirements.

Mr. DINGELL. Is that in your rules or is that in the SEC's rules?

Mr. LUDWIG. That is in the SEC's rules.

Mr. DINGELL. That has nothing to do with the movement of capital, does it?

Mr. LUDWIG. Well, it does. They cannot move the required net capital out of the subsidiary.

Mr. DINGELL. I do not think you are answering my question. Let's look. Here the bank says to—here Mellon says to Dreyfus, you are going to move $200 million to the bank. Now, that money is staying in the overall bank, and the overall structure of the bank is a solid bank. You are happy because now the bank has another hundred or $200 million in capital. That makes you feel good because you are sure of the soundness of the structure of the bank. Then, what about Dreyfus? Dreyfus has moved capital from Dreyfus to Mellon at the instruction of Mellon. What particular rules do you have with regard to the movement of this capital or the capital adequacy of Dreyfus?

Mr. LUDWIG. The SEC rules, which apply to them now and which limit the movement of capital. In other words, they would be no less or no more able to move capital out of Dreyfus as a result of the acquisition——

Mr. DINGELL. Do you enforce SEC rules?

Mr. LUDWIG. Through 1818 we sure do.

Mr. DINGELL. You do?

Mr. LUDWIG. Yes, sir, we do. If they violate the net capital——

Mr. DINGELL. Do you have a rule that says you enforce SEC rules on this matter?

Mr. LUDWIG. 12 USC 1818.

Mr. DINGELL. I beg your pardon?

Mr. LUDWIG. 12 USC 1818.

Mr. DINGELL. That is simply you cease and desist order. That is essentially—that empowers you to tell people to stop doing things.

Mr. LUDWIG. That empowers us to issue civil penalties, to remove people from banks, if they violate law. If they violate the SEC rules, they are violating law, and we can impose the full panoply of our enforcement powers.

Mr. DINGELL. This is not an unsafe or unsound practice in banking. It may be an unsafe or unsound practice with regard to the security subsidiary, but it's not an unsafe or unsound practice with regard to the bank.

Mr. LUDWIG. The change in ownership doesn't change the applicability of the SEC——

Mr. DINGELL. I'm sorry?

Mr. LUDWIG. The change of ownership doesn't change the applicability of the SEC standards. The one thing that does change, actually, is that you have, in a sense, two agencies——

Mr. DINGELL. We are not talking about the SEC's. Tell us where your standards might be.

Mr. LUDWIG. We incorporate them by reference.

Mr. DINGELL. Where do you incorporate them by reference?

Mr. LUDWIG. Under 1818.

Mr. DINGELL. Well, earlier you said it's not important that they be sanctioned. It's just important that they just get it right. Now, we've been talking about the behavior of people who are selling securities out of the bank. I gather we're talking about people who pull capital out of brokers and put it into the bank.

What I sense you're telling me here, in spite of what you said earlier, is there is nothing in your rules that restricts the ability of the bank to drain the capital from a broker-dealer subsidiary right down to the bare minimum required by the securities laws. Is that right?

In other words, as long as they meet the bare minimum that's required by the SEC, they can pump all the capital they want out of that.

Mr. LUDWIG. Isn't that the case now with respect to the current ownership? If the current ownership wanted to take capital out, they would have to comply with the SEC rules. After the transaction, they would have to comply with the SEC rules, as well.

Mr. DINGELL. I'm not going to quarrel with you about that. In any event, to the extent that a subsidiary has capital in excess of regulatory minimum, the bank is then free to take it and use it for its own purposes, isn't it? And it can declare dividends from it. It can make further investments with it. It can do whatever it wants with those moneys above the bare minimum. Is that right?

Mr. LUDWIG. Well, I don't want to prejudge what we will do with the application. I would say that for a subsidiary of a bank, we look at the capital on a consolidated basis. In terms of setting the capital standards for the banking organization, we take into consideration a variety of activities that can be engaged in by the bank and a subsidiary, so that the combined entity is well capitalized.

We have very detailed rules on capitalization of banking organizations. They are very detailed and we'd be happy to submit them for the record.

Mr. DINGELL. Let's go back to 1818 issues that we had been discussing before. Am I fair to infer that this is a charter to protect and amend—and a power to protect the banks? I'm still curious about where in 1818 we find anything which mandates you to protect the investor or the consumer of nonbank services here.

Mr. LUDWIG. Well, 1818 applies to the banking organization.

Mr. DINGELL. Pardon?

Mr. LUDWIG. Our 1818 authority applies to the banking organization, including the operating subsidiary. As I've mentioned before, that 1818 authority says that you can't violate law, you can't operate in an unsafe and unsound manner.

Mr. DINGELL. That means operate a bank in an unsafe or unsound manner.

Mr. LUDWIG. Banking organization.

Mr. DINGELL. Where does it say that you don't engage in insider trading, manipulation, frontrunning or other practices that would be prohibited by the securities laws?

Mr. LUDWIG. As I said, if you violate the securities laws, you are violating 1818 and we would feel free to use our entire panoply of powers against the institution.

Mr. DINGELL. Mr. Ludwig, are you familiar with the Policy Statement on Mutual Funds filed by Mellon Bank as a part of its notice or application with you?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. The document referred to says it provides a number of guiding principles designed to ensure consumer protection,

prevent conflicts of interest, provide for the safety and soundness of both Mellon Bank subsidiaries and the funds. Isn't that so?

Mr. LUDWIG. That sounds right to me, yes. Here it is. Yes.

Mr. DINGELL. The general areas covered by the Policy Statement include: independence of the mutual fund boards; independence of the fund; relationship between Mellon and the advised funds (including extensions of credit and purchases of securities); conflicts of interest; consumer protection (with particular emphasis on suitability and ensuring that the customer understands that mutual fund shares are not FDIC-insured or bank obligations); SEC regulation; board of directors and management oversight; and compliance reviews.

Now, the American Heritage dictionary that we've been referring to defines "voluntary" as "acting on one's own free will or one's own initiative" and "acting or performed without external persuasion or compulsion or without legal obligation."

Accordingly, then, is this statement, which is essentially a voluntary document and which defines itself as being voluntary, a document which carries with it the force and effect of law and is it a regulatory document?

Mr. LUDWIG. Let me answer that a couple of ways. Were we to accept this statement or a statement like it, we would enforce violations of this statement.

Mr. DINGELL. How can you do that? This is a voluntary statement.

Mr. LUDWIG. We can include it as a condition of our approval. But even if it's given by a bank voluntarily, and it was the basis of our approval, we would view a violation of it as something that we would——

Mr. DINGELL. You're saying then that you are going to require this to be a condition of approval.

Mr. LUDWIG. I am saying that when we come out with our application or give approval, if we do, we will quite possibly include conditions. The conditions may be more extensive than this, they may be these, they may be whatever. But whatever is included as the basis of that approval we will expect to be enforceable.

We are certainly not going to approve something on the basis of representations that we don't believe are enforceable.

Mr. DINGELL. But we've been talking about 1818(b)(1). Mr. Ludwig, that provision states in relevant part that you are authorized to seek cease and desist orders based on, and I quote, "reasonable cause to believe that the bank or any director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank is about to violate a law, rule, or regulation, or any condition imposed in writing by the Agency in connection with the granting of any application or other request by the bank or any written agreement entered into with the Agency."

Now, I want to ask you a series of questions about what I've just read and I would request that you answer just yes or no. Are voluntary commitments a law?

Mr. LUDWIG. They're not a law.

Mr. DINGELL. Are voluntary commitments rules or regulations?

Mr. LUDWIG. Not rules or regulations.

Mr. DINGELL. Beg your pardon?

Mr. LUDWIG. They're not rules or regulations.

Mr. DINGELL. Mellon's testimony says they're "willing to have the commitments set forth therein converted into conditions of regulatory approval should the OCC so desire." Your testimony states: "if we were to approve the Notice, the written conditions the OCC, at a minimum, would likely impose would cover the voluntary commitments set forth in the Policy Statement."

Now, that leaves us the great big question. Are you going to impose the Policy Statement's voluntary commitments as conditions imposed in writing by the OCC in connection with the granting of the Mellon-Dreyfus application, should you decide to approve the transaction?

Mr. LUDWIG. I don't mean not to be forthcoming. I think I've been clear about our seriousness in enforcing the application and conditions of its approval, but I really don't want to make statements about our application. I can assure you that we take it seriously and we might well impose conditions. But when we have an application before us and I'm the judge, it seems to me that I've just got to not prejudge it and give you that kind of assurance.

Mr. DINGELL. You have in a number of instances—for example, in the case of First Union, at least initially, not put these matters out for public comment. Does that represent a change in policy when you now have First Union essentially out for comment, as well as Mellon-Dreyfus out for public comment? Is that a practice that you're going to continue from now on?

Mr. LUDWIG. I'm glad you raised that question. I committed when I came in to review all our rules and regulations from A to Z. We're in the process of revising our entire rule book. One of the areas we're revising is Part 52 that deals with this kind of issue.

We have under consideration—had under consideration when this came in—putting this kind of application out for public comment. To be honest, we might not have done so because we're in the process of revising the rules.

You and Chairman Gonzalez raised the issue of whether or not this should be out for public comment. Given the magnitude and the complexity of these transactions, it seemed to us that although it was on a sui generis basis because we haven't revised our rules yet, it made sense to go ahead and do it. Incidentally, I misstated myself. It's Part 5, not Part 52, we're changing.

But we realized the benefit of public comment in complex and large situations and we are revising our rules with that in mind. That's one of the reasons we decided that it made some sense in this case to go ahead and put it out for public comment.

Mr. DINGELL. I would note that we find ourselves in a situation where others previously have not been required to meet this kind of an open process and that others in the future may or may not be required to meet this kind of open process.

I'm curious. Is an open process desirable or undesirable in this instance?

Mr. LUDWIG. I think an open process is very desirable. Let me say the interesting thing about our rules is that we really have quite a bit of transparency in terms of the public. Everything is available to the public in bulletins and FOIA requests, et cetera.

One of the problems with our rules is that there are disclosures here and disclosures there and they're not made in a coherent fashion. One of the things we want to change is to make them accessible to the public, so that the public disclosures are easily identifiable. This kind of open comment period, I think, is desirable in complex and large situations like this.

We're working hard to change our rules so that we do, indeed, address this kind of issue.

Mr. DINGELL. Let's look at this, because heretofore you have announced these by bulletin, have you not? Essentially, you put out a bulletin.

Mr. LUDWIG. That's right.

Mr. DINGELL. What has preceded that bulletin in the way of public rulemaking?

Mr. LUDWIG. We historically give public notice after an application is filed.

Mr. DINGELL. I'm sorry?

Mr. LUDWIG. We historically have given public notice after an application is filed.

Mr. DINGELL. How much detail has that had?

Mr. LUDWIG. It is not very detailed.

Mr. DINGELL. Has it identified the applicant?

Mr. LUDWIG. Yes.

Mr. DINGELL. It has. In all cases?

Mr. LUDWIG. I believe that's correct. I'd have to get back to you, but I'm virtually certain that's correct.

Mr. DINGELL. Does it identify the powers being sought?

Mr. LUDWIG. Currently it does not and it's one of the areas of change that we will be considering. There's no doubt about it. That's one of the reasons we're looking at changing this whole area. If we thought it was perfect, we wouldn't be changing.

Mr. DINGELL. What does it just say, then? It says so and so has made an application to the OCC, but it doesn't say what the application is for. Is that right?

Mr. LUDWIG. That's correct.

Mr. DINGELL. What does the announcement, the bulletin which announces what's been done, say? Does it identify the applicant?

Mr. LUDWIG. Well, where there are novel and important cases, not only does the bulletin go into some description, but also the interpretive letters are often made quite public. That is, they're all public, but they're also published.

Mr. DINGELL. What is a novel or important question that's decided? In other words, some are going to be publicly announced and some are not going to be publicly announced. I'm trying to find out which ones are going to be announced publicly because they're novel and important and which ones are not.

Mr. LUDWIG. Where they depart materially from past——

Mr. DINGELL. Pardon?

Mr. LUDWIG. Where they depart materially from past precedent would be the basis on which one would conclude that they were novel.

Mr. DINGELL. Isn't this the public's business?

Mr. LUDWIG. Pardon me?

Mr. DINGELL. This is public business. You're saying a bank can do this or a bank can't do that.

Mr. LUDWIG. Let me say that all the approvals and all the interpretations are publicly available. The issue is not whether they're publicly available. The issue is whether or not we have the kind of mechanism in place that incorporates public comment and where the documents are easily accessible to the public, and that's why we're changing. That's why we're in the process of revising.

Mr. DINGELL. Let me ask you. Are you subject to the Administrative Procedures Act?

Mr. LUDWIG. Absolutely.

Mr. DINGELL. You are?

Mr. LUDWIG. Absolutely.

Mr. DINGELL. The Administrative Procedures Act, when you take a regulatory act of this kind, requires, first of all, notice; second of all, opportunity for comment; and, in many instances, it mandates a hearing and a public process. Then it mandates that you should announce your process or, rather, the result of your process in an opinion which is subject to judicial review.

How have you been able over the years, then, not to comply with those requirements?

Mr. LUDWIG. The op sub notices are not subject to the APA.

Mr. DINGELL. Pardon?

Mr. LUDWIG. The op sub notices are not strictly subject to the APA. It's one of the reasons we're changing in this area.

Mr. DINGELL. These are functioning under an exception from the APA.

Mr. LUDWIG. Let me get back to you in writing on that question in some detail.

Mr. DINGELL. All right. Mr. Ludwig, I note that there is a vote on the floor. We have much more to do here. Would it meet your approval if we were to recess for, let's say, 1 hour so everybody can get some lunch and come back at 2:00?

Mr. LUDWIG. Sure.

Mr. DINGELL. Then that's what we will do. We will return at 2:00. In the meantime, the committee will stand in recess.

[Whereupon, at 1:02 p.m., the subcommittee was recessed, to reconvene this same day at 2 p.m.]

AFTER RECESS

Mr. DINGELL. Mr. Ludwig, last evening you delivered to the subcommittee a letter dated March 3 in response to an investigative letter of February 23 by the subcommittee. That document included a list of all approvals. I counted 65 granted since 1985, the year your database began collecting such information for national banks to engage in investment advisory services through operating subsidiaries.

The list includes both acquired and de novo operations in the national bank operating subsidiaries. I want to thank you for this information.

You have put out for public comment, as we have noted earlier, Mellon's proposed acquisition of Dreyfus and First Union's proposed acquisition of Lieber and Evergreen. Will you apply the same requirements to everyone? Because as of this particular minute,

you have leveled these requirements on two, but apparently not on others.

Mr. LUDWIG. Mr. Chairman, two things I'd like to make clear. I just want to make certain. The document we submitted last evening was not complete. We submitted a substitute this morning because there had been a computer error.

Ms. WASHINGTON. You are correct. The document that you submitted last evening had a list of 33.

Mr. LUDWIG. Fine. Just so you have the complete——

Ms. WASHINGTON. We received the new document and the chairman used the new number, which is 65.

Mr. LUDWIG. That's fine. I just want to make sure. As I mentioned, we are looking very hard at changing our Part 5 so that novel and complex applications of this sort are subject to a public comment period. We're in the process of reviewing that regulation right now.

Mr. DINGELL. We've dealt so far with the questions with regard to the procedure; in other words, whether these would be put out for comment and that sort of thing. But we have not discussed whether you would impose the same regulatory requirements on all these people. In other words, are you going to impose one set of regulatory requirements, for example, on Dreyfus and Mellon and perhaps on First United or are you going to impose them on all previous and all subsequent applicants?

Because you have defined a certain set of rules and procedures that you've indicated to us you expect to see followed by the banks which go into this kind of activity. I'm curious. Would you then apply these same kind of requirements to others, including those previous or those who will come after?

Mr. LUDWIG. In many cases, maybe even most, and we're prepared to provide to the committee the specific approvals, we have, in fact, imposed conditions or have had commitments that we thought were substantial.

Your question as to whether or not there is a core here of requirements that we might impose on a consistent basis is something we're looking at and considering.

Mr. DINGELL. Here's the situation. You have two banks doing business in the same State or same town. They have branches across the street from each other. If you apply one set of rules to one and one set of rules to another, you have a competitive advantage or disadvantage between the two.

If you apply one set of rules, for example, in Michigan and another set in Ohio, you, again, have a different competitive situation and money flows according to the most advantageous return to the holder of the money.

My question is doesn't fairness require that you achieve a level playing field on this matter?

Mr. LUDWIG. With respect, we very much want to achieve a level playing field. Let me say, however, that in terms of these individual applications, depending on the application and the actual activity involved and the precise nature of an institution's business, we might well impose conditions that would be idiosyncratic to the individual institution in terms of our concerns about safety and soundness in the specific case. So while we may well come to a core

of requirements, we might well have certain approval-specific requirements in one case that we might not have in another.

Mr. DINGELL. So you have, then, the question of both investor protection and, very frankly, the question of fairness between different participants in the financial business, and you would want to achieve fair treatment of both.

Mr. LUDWIG. Absolutely.

Mr. DINGELL. All right. Mr. Ludwig, there is a rather simple solution out of this quagmire. Rather than having you have to stretch the interpretation of your statutes, it appears to me to be quite sensible to simply repeal the bank investment adviser and broker-dealer exclusions in the securities laws and to impose the voluntary commitments in Mellon's policy statement by law.

Mr. Moorhead, Mr. Markey, Mr. Fields and I have a little bill, H.R. 3447, that would do just that. Would you have any strong objections to us doing that?

Mr. LUDWIG. Well, the administration does not have a position on that legislation at this time. As a matter of fact, we do take, as you know and as I think you'll hear today, a number of your concerns seriously. At the same time, we don't have a position on the legislation and I'm not at liberty to take a position on it.

Mr. DINGELL. Of course, Mellon's policy statement adopts most of the provisions of H.R. 3447. Their testimony acknowledges that fact. The Mellon-Dreyfus letter of February 18, 1994 to the subcommittee says that this "reflects Mellon's and Dreyfus' agreement with Chairman Dingell's statement that H.R. 3447 provides a strong and responsible framework for functional regulation to strengthen taxpayer and investor protections in the wake of recent decisions allowing banks to expand their securities activities."

Would you be willing to work with the committee to help get H.R. 3447 enacted?

Mr. LUDWIG. As I said, the administration doesn't have a position on the legislation and I'm not at liberty at this point to make that commitment.

Mr. DINGELL. I would be rather naive if I didn't assume that you had a substantial influence on the position that the administration is ultimately going to take.

Mr. LUDWIG. I would have some.

Mr. DINGELL. Now, Mr. Ludwig, some of us had the privilege of watching your Senate testimony on consolidation of bank regulators on C-SPAN yesterday and you said one thing which I thought was very interesting and I think quite persuasive. You said: "one bank regulator is necessary because fraud could fall through the cracks." You also said: "one uniform set of rules should apply to all banks."

Earlier this week, Secretary of the Treasury Bentsen was quoted as saying "Bank regulation should not be like Noah's Ark—two of everything." Also, yesterday's Wall Street Journal article, "Senate Banking Panel Hears Regulatory Plan," reported that Secretary Bentsen called the cost and complexity of overlapping regulation "a serious disadvantage in today's competitive world."

Do you agree with those statements?

Mr. LUDWIG. I agree with those statements.

Mr. DINGELL. Mr. Ludwig, I then find it somewhat amusing and I think a little bit inconsistent the way things are going. You are out creating a second SEC within the OCC. I'm not sure that you really need to go to all that sweat and blood and tears and suffering to achieve it when we have a perfectly good SEC out there ready, willing and able to regulate people who are doing the business, that they regulate in exactly the same way that they regulate everybody else that does that business.

Doesn't this have a modest level of appeal to you?

Mr. LUDWIG. I understand your functional regulation argument, and I can say that given our current system, there is, I think, a valued cooperative effort between our regulatory apparatus and the SEC. The difference with a consolidated bank regulator is that what you're doing is regulating the same type of entity. Why have different regulators regulating the same type of entity different ways?

In respect to the SEC versus the bank regulator's jurisdiction, the bank is a specialized entity. And it seems to me as long as there is cooperation, using our mechanisms in a cooperative and genuinely forthcoming manner, we can do a good job.

Now, I'm not saying that that's the ultimate solution or the best solution. I'm saying that we're working with the system we have and we're trying to do it aggressively and effectively.

Mr. DINGELL. One of the things that seemed to make the Chairman of the SEC sad, and he seemed to be quite sad about it, was the fact that somehow or other, never have you and he or your Agency and his Agency gotten into firm agreement on how you're going to regulate the banks in their securities activities; that you held infrequent meetings; that your meetings had brought you to no successful conclusion of the controversies between you or the issues that you were trying to address.

Can you tell us of any solid agreements you have with the SEC which relate to their conduct of their business and the conduct of your business with regard to broker-dealers or people who are providing full broker-dealer services inside banks?

Mr. LUDWIG. Absolutely. We have agreed with them. We don't have it in writing, but we have agreed with them and are working with them on a consumer study and on various enforcement actions which are going on right now.

Mr. DINGELL. You've agreed that you were going to work with them. Do you have a memorandum of understanding with them?

Mr. LUDWIG. We do not have a written memorandum of understanding.

Mr. DINGELL. You have agreed with them that you're going to work together. Now, what form has that agreement taken? That you're going to apply their rules to the bankers who are engaged in the sales of securities inside the bank's premises or by a bank's subsidiary?

Mr. LUDWIG. I am definitely committed to a more cooperative effort.

Mr. DINGELL. More cooperative. Now, when you tell me you're going to be more cooperative, does that mean that you've been less cooperative up till now? I'm trying to understand this. I get the inference that perhaps up till now you've been less cooperative.

Now, this comforts me greatly to understand you're going to be more cooperative, but the question is why have you been less cooperative and how are you going to be more cooperative?

Mr. LUDWIG. Well, I think there is a great deal of cooperation that we can achieve with the SEC which past Comptrollers have not. I think that both the Chairman of the SEC and I are committed to that. We've met several times, our staffs are meeting, and we're doing a great deal more together than has been done in the past.

Mr. DINGELL. Well, he didn't seem as comfortable with this matter as you do. The record says that there's a lot of things that he would like to do with regard to people who are selling securities, on matters where it's affecting the integrity and the soundness of the market, and he can't do them because under your law and his law, he can't go in there and do it.

He couldn't tell us. I asked him to tell us of one concrete agreement, one concrete conclusion which he had arrived at which would make his mission and your mission of regulating the sales of securities out of banks more effective, and he couldn't tell me of any.

So my question to you is what have you done in terms of coming to a solid agreement with him that makes the regulation of securities sold by banks better?

Mr. LUDWIG. Well, we don't have a written agreement. I take your point on a written agreement, and maybe there's some value in it. It's something we haven't explored together, but we are working more cooperatively than the organizations have worked in the past, and we intend to continue.

Mr. DINGELL. Go ahead. I'm sorry.

Mr. LUDWIG. I'm sorry. I said that we intend to continue to work cooperatively.

Mr. DINGELL. Would you submit to us, please, a list of any and all meetings that you've had with the SEC or that officials of the OCC have had with the SEC.

Mr. LUDWIG. Absolutely, pleased to do so.

Mr. DINGELL. The conclusions that were arrived at at the meetings, the subjects which were discussed, the agreements which were achieved, and the progress which was made on the issues that are before two of you which relate to the sale of securities by banks.

Mr. LUDWIG. Absolutely. We'll be pleased to do it.

Mr. DINGELL. Now, I guess we've got to get this—we're talking here about a broker-dealer who is inside a bank and a broker-dealer who is outside the bank. The broker-dealer outside the bank is regulated by the SEC. The broker within the bank is regulated by OCC.

Why should that be?

Mr. LUDWIG. Well, I must say that we have, I think, a very able supervisory force, as I mentioned, and I think we do a good job. I think we can enforce these rules well using our supervisory mechanism.

Mr. DINGELL. Well, here is what you said the other day. You said "one bank regulator is necessary because fraud could fall between the cracks." Can't you substitute "one securities regulator" for that so that fraud doesn't fall between the cracks?

Mr. LUDWIG. We're certainly committed to no fraud falling between the cracks.

Mr. DINGELL. You are committed to that, but how can you give me the firm assurance that this situation is going to work that way?

Mr. LUDWIG. As I mentioned, we can enforce the securities laws, the fraud provisions of the securities laws, and——

Mr. DINGELL. What is there that is so unique about a bank that the securities laws should be enforced by a bank regulator rather than by a securities regulator?

Mr. LUDWIG. I would say——

Mr. DINGELL. Same document, same obligations, same financial questions, often the same buyers. Why does this require your special attention rather than the attention of the SEC and the application of this wonderful document which you asked people to refer to, the manual of the NASD?

Mr. LUDWIG. The fact that we're in these institutions all the time, I think, is advantageous in terms of actually enforcing seriously in this area. I think there is a virtue to using the various arms of the Federal Government in an efficient fashion. That is to say we're in there anyway and we're also doing a serious job in a variety of areas of the institution.

We have a number of people in this enforcement area in our mutual fund effort that I think are being put to good use.

Mr. DINGELL. Do you want me to believe that your success in giving firm protection to the Widow Goodbody is complete and that she is receiving the same protection with regard to the securities that she gets from her banker that she is when she goes down to somebody who is regulated by NASD?

For example, your capital requirements are different. Your rules on paper trails are different. Your rules on insider trading are different. Your rules on frontrunning are different. You actually have no specific legislative powers to address these matters.

Now, while we're talking about that, what specific rules do you have on frontrunning, any?

Mr. LUDWIG. As I mentioned, we have our Part 9 trust powers, fiduciary powers that would apply in this case, and we have our Part 12 disclosure rules.

Mr. DINGELL. Those are sort of general. How about insider trading? What specific rules have you got? The same rules?

Mr. LUDWIG. Violations of insider trading rules would violate all kinds of things. They would violate the fraud provisions of the securities laws, which we can apply. They would violate our fiduciary rules, and we would use our 1818 powers in this kind of a case.

Mr. DINGELL. Would you submit to us a list of all the actions taken against banks which were engaged in the securities business by the OCC where insider trading, frontrunning, conflict of interest, lack of proper supervision or failure to supervise, unsuitability, which is a major question, and also any questions that relate—rather, any other enforcement proceedings which you've had over time? Would you do that for us, please?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Mr. Ludwig, an insurance company and its employees who want to sell securities and render investment advise have

to register with the SEC. Why is a bank different in this matter than an insurance company or registered broker-dealer? What is it that requires—what unique character in the bank requires them to be treated differently than an insurance company or registered broker-dealer in the securities business?

Mr. LUDWIG. In respect to national banks, you've got a national charter and, in essence, national registration. Why on earth would you want to have them registered twice? I mean, I can understand the benefit of registering a company that is otherwise unknown as a broker-dealer with the SEC because otherwise it's just simply out there. The banks are already, if you will, federally-registered by reason of obtaining a national charter.

Mr. DINGELL. That's the best reason you could give, that they've already registered with you folks. I think you've conceded that you've not done as good a job of regulating them on these matters as you could.

Ms. BROADMAN. May I make a brief point? For registered banks under the 1934 Act, the OCC has cross-referenced the SEC rules. So the same rules apply. With respect to bank offerings, our rules are similar, but we have put out for public comment and we are in the process of rewriting our rules so that they are comparable to the SEC rules, as well. So that there is similarity here. I think the OCC has recognized the value of a level playing field.

Mr. DINGELL. This is all very good, but we've agreed that, first of all, one, the rules that you apply are quite different in the instances that I've alluded to frontrunning, insider trading and that sort of thing, suitability. As a matter of fact, from what I could read with regard to the applications that I gather you're receiving, they are different between banks.

Mr. LUDWIG. It's not so much that the rules are different between banks. But if you're going to have an acquisition situation where you're dealing with different facts and circumstances in terms of safety and soundness responsibilities, I don't think you can guarantee a one-size-fits-all approval. I don't think it can be.

Mr. DINGELL. All investment advisers and all broker-dealers who are registered with the SEC have to comply with the same rules. So what we're seeing here is the situation where Mellon-Dreyfus and First United Bank and Evergreen and Lieber are going to be complying possibly with different rules, or, if they are complying with the same rules, they may very well be complying with different rules than all the other 65 or so cases to which we've referred in the past and may very well perhaps be confronting, again, different rules than others will be confronting.

Mr. LUDWIG. As I say, I can see that there is value in identifying a core set of rules by way of the commitments that have been given which ought to apply on a consistent basis across institutions. But as you well know, a bank acquiring a subsidiary engaged in investment-related activities is a serious business. It's serious for the investee, for the public, and serious for the safety and soundness of the institution. We would not want to lock ourselves into a one-size-fits-all set of rules.

Mr. DINGELL. Are you telling me, then, that you want to have different rules for everybody or perhaps that you wish to have the ability to establish different rules for everybody?

Mr. LUDWIG. I don't believe that the rules are materially different now, and they wouldn't be materially different on a going-forward basis in terms of the responsibilities of the institution.

Mr. DINGELL. You're telling me you don't regard these rules as materially different, but you are having different rules. They're either identical or they are materially different.

Mr. LUDWIG. They can be different, but not materially different.

Mr. DINGELL. Or not materially different. But not materially different doesn't mean not different.

Mr. LUDWIG. It doesn't mean not different.

Mr. DINGELL. So you have different rules.

Mr. LUDWIG. It's something I'd like to go back and think about. I think I could give you a hypothetical case where you wouldn't want to permit an acquisition or you would want to so condition it, given the state of the bank's financial picture, or other reasons that would not necessarily go to the questions of how investment products are sold or what kind of suitability requirements are applied. The reasons would go to the individuality of the institution.

Mr. DINGELL. Here we've got poor, dear Widow Goodbody going in and if she goes into one bank, she's going to be addressing one set of suitability rules. If she goes into another, she's got to be addressing another set of suitability rules. If she goes into 40 or 50 banks, probably she's going to face a different rule in each and every one of them.

I wonder if that's in the best interest of the Widow Goodbody.

Mr. LUDWIG. It seems to me that what I've said——

Mr. DINGELL. It's in the interest of the banks, I'm sure, but is it in the interest of poor Widow Goodbody?

Mr. LUDWIG. Well, as I've said, we want to make sure the suitability rules here are at least as good as the NASD rules.

Mr. DINGELL. I applaud you for the fact that you want to be careful, but during the time that you and I are sitting here talking, banks are selling a fairly good part of their $2 billion sales in their mutual funds and other financial instruments.

Mr. LUDWIG. What if you had a bank—in fact, we do have banks that really will go quite far on their own to have what you might call exceptional suitability and other standards which far exceed the norm. We'd want to encourage that, as well. We want to encourage that, as well.

Mr. DINGELL. I do, too. But, again, you have some that are meeting extraordinarily high standards and then you have some that may be meeting less than extraordinarily high standards.

Mr. LUDWIG. And we intend to go after the ones that are meeting less than adequate standards, as I mentioned, and make sure that they are meeting——

Mr. DINGELL. You've got 3,400 banks. You've looked at 300 of them.

Mr. LUDWIG. Three hundred.

Mr. DINGELL. And you've got 3,100 unlooked at. You don't really know what you found in the 300 that you've looked at and you don't have any idea what's going on in the other 3,100.

Mr. LUDWIG. I don't admit that we don't know what we found in the 300.

Mr. DINGELL. Pardon?

Mr. LUDWIG. I don't admit that we don't know what we found in the 300. Indeed, we're prepared to submit to you any changes that we've asked for in those institutions in terms of their practices.

Mr. DINGELL. The difference between us is you're a very trusting fellow and I'm not. I like to be sure that where I'm talking about Widow Goodbody and the other folks I'm supposed to look at here that the Widow Goodbody, when she walks in, she's going to know she's going to get something suitable.

You're telling me that you're telling them to sell them something suitable and then they will sell her something that they think is suitable. Now, it may be suitable to Widow Goodbody's financial interest or it may be suitable to the commission of the seller.

Now, does she—we've talked about this—does the Widow Goodbody under your rules and regulations have the right of rescission?

Mr. LUDWIG. As I mentioned, there have been 14 cases in the last year out of——

Mr. DINGELL. Fourteen.

Mr. LUDWIG. Out of 15,000 complaints, we only had 14 in the mutual fund area, and of those 14, 7 were associated——

Mr. DINGELL. Does she have a right of rescission under your rules? Yes or no?

Mr. LUDWIG. I'm sorry. Maybe I wasn't clear. Of the 15,000 complaints, 14 were in the mutual fund area. Seven of them involved rescission for the——

Mr. DINGELL. How many of them got rescission?

Mr. LUDWIG. Seven of them.

Mr. DINGELL. All of them.

Mr. LUDWIG. Seven.

Mr. DINGELL. Is that because of the rule or because you and your folks at OCC, out of the goodness of your heart, went to the bankers and said you might have problems if you don't give her her money back? Is it because you had a clear rule or not? Do you have a clear rule on this?

Mr. LUDWIG. We can order rescission.

Mr. DINGELL. Pardon?

Mr. LUDWIG. We can order rescission.

Mr. DINGELL. You what?

Mr. LUDWIG. We can order rescission. Our rules permit us to order rescission.

Mr. DINGELL. If they permit you to order it, but she has no right on her own to rescind. She's got to come hat in hand to you.

Mr. LUDWIG. Yes.

Mr. DINGELL. Is that right?

Mr. LUDWIG. If it's fraud, she can bring an action.

Mr. DINGELL. She's got to come hat in hand to you to get you to order——

Mr. LUDWIG. If it's fraud, she can bring a private right of action.

Mr. DINGELL. Without fraud, on just the question of suitability, does she have the private right of action?

Mr. LUDWIG. If it isn't fraud, she brings the case to us, and we've found that, as I mentioned, in those cases, at least, it's been an effective remedy.

Mr. DINGELL. So she's got to come to you instead of going to the courts.

Mr. LUDWIG. Other than in fraud cases right now, I think that's correct.

Mr. DINGELL. On fraud cases, she can go to the courts, right?

Mr. LUDWIG. Yes.

Mr. DINGELL. Now, does she have the right to come to you, too?

Mr. LUDWIG. She does have the right to come to us, as well.

Mr. DINGELL. And what happens? Will you put in the record the specific rules that you have with regard to the rights of somebody who is aggrieved by fraud?

Mr. LUDWIG. Yes, sir.

Mr. DINGELL. Does she have the right to arbitration?

Mr. LUDWIG. In the banking context, certainly where there's a subsidiary, she would be covered by the securities laws and applicable right to arbitration.

Mr. DINGELL. Not if they're not registered with the SEC.

Mr. LUDWIG. That's what I said. When you get into the bank——

Mr. DINGELL. Are these cases that you're referring to all cases in which the rights that the aggrieved party has because she is dealing with a registered broker-dealer or because you have some specific provision in your statute?

Mr. LUDWIG. No. In the 14 cases, I can't tell you, frankly, whether or not they involved registered broker-dealers. But I can tell you that it would make no difference to us; the complaints are handled the same and the remedies would be meted out the same from the perspective of our complaint process.

Mr. DINGELL. So there is no right of arbitration. I want you to cite to us the specific provisions in your rules and in your statutes and in your regulations which confer rights on the persons that I have described as being aggrieved in these particular instances.

Mr. LUDWIG. I will definitely do that.

Mr. DINGELL. So we can have that for the record. Mr. Ludwig, we thank you very much for being with us. We appreciate your kindness. We will probably have some other inquiries. Since you're going to be broadly in the securities business, I suspect we'll be seeing quite a bit of each other.

Mr. LUDWIG. I expect that. Somehow I'm not surprised.

Mr. DINGELL. I'm sure we will both enjoy it and look forward to our visits which will occur, I think, fairly regularly.

Mr. LUDWIG. I'm not surprised.

Mr. DINGELL. Mr. Ludwig, we want to thank you and we should probably both learn these new statutes that we are going to have to learn. I know you're going to have to learn the securities statutes and I would suggest that we should commence doing so with all vigor, because, as I've indicated, I think we will, now that you're in the securities business, see rather more of you and we look forward to it.

Mr. LUDWIG. Thank you, sir.

Mr. DINGELL. We thank you. The next witnesses are a panel composed of Mr. Frank Cahouet, Mr. Martin G. McGuinn, Mr. Howard Stein, and Mr. Joseph DiMartino. Gentlemen, we thank you for being with us. We apologize for keeping you so long, but

as you know, this has been a matter which has been carried forward with great enthusiasm by both Mr. Ludwig and myself.

We thank you for being with us. You have heard the fashion in which the committee conducts its business. Do any of you object to testifying under oath?

[No response.]

Mr. DINGELL. Very well. The Chair would also inquire do any of you desire to be advised by counsel, given the fact that you are testifying under oath?

[No response.]

Mr. DINGELL. The Chair would observe that copies of the rules of the subcommittee, the rules of the committee and the rules of the House are there to advise you of your rights and limitations on the power of the committee.

Gentlemen, if you have no reservations about testifying under oath, if you would, please, each rise and raise your right hand.

[Witnesses sworn.]

Mr. DINGELL. Gentlemen, you may each consider yourself under oath. We will recognize you for such statement as you choose to give. You may submit your statements in such order as you choose. One of you may testify on behalf of all or several or you may each proceed in your order. We leave the choice of your statement to you, gentlemen, with our good wishes.

TESTIMONY OF FRANK V. CAHOUET, CHAIRMAN, MELLON BANK CORP., ACCOMPANIED BY MARTIN G. McGUINN, VICE CHAIRMAN; AND HOWARD STEIN, CHAIRMAN, DREYFUS CORP., ACCOMPANIED BY JOSEPH S. DiMARTINO, PRESIDENT

Mr. CAHOUET. Mr. Chairman, Mr. Stein and I would like to make opening statements, with your permission.

Mr. DINGELL. Very well.

Mr. CAHOUET. And Mr. McGuinn, on my left, is Vice Chairman and he is in charge of the retail group within the bank. Mr. DiMartino is the President of Dreyfus Corporation.

To begin my statement, my name is Frank V. Cahouet and I am Chairman, President and Chief Executive Officer of Mellon Bank Corporation and Mellon Bank. I appreciate this opportunity to respond to your questions regarding our proposed transaction with the Dreyfus Corporation.

I want to emphasize three basic points at the outset. First, Mellon shares the concerns that the chairman and other members of this subcommittee have expressed regarding depositor and investor protection and bank safety and soundness. Second, Mellon has put into place comprehensive policies and procedures which are designed to address those concerns. We have done so not only as a matter of compliance, but also because of our 125-year track record of building lasting customer relationships.

Third, Mellon and Dreyfus share a compatible culture and tradition of conservatism and concern for the consumer. Together we are uniquely well positioned to complete this transaction in a manner that assures consumers' best interests.

Given our carefully planned approach to this union between Mellon and Dreyfus, we respectfully submit that the proposed trans-

action will, one, be beneficial for consumers; two, will provide to purchasers of Dreyfus mutual funds substantial protections that extend beyond industry practice; and, three, will result in a stronger Mellon, better able to play its rightful role for customers and shareholders and within the economy.

Let me discuss each of those conclusions in greater detail. Consumer benefits. The Mellon-Dreyfus transaction is beneficial to the consumers because it responds to what many consumers have said they want, a convenient, single source of financial services, preferably a bank which offers mutual funds.

Indeed, the 23 percent annual growth rate in mutual fund assets over the last 12 years as compared to a 6.3 percent growth rate in bank deposits clearly attests to the fact that mutual funds have become an investment vehicle of preference. Mellon's three-State branch network, when coupled with Dreyfus' extensive teleservicing capabilities, has a potential to greatly enhance convenience of access for both Mellon and Dreyfus customers and potentially for millions of other customers.

This transaction also means that professional financial advice will be easier to obtain for those customers at a time when they must make ever more complex personal financial decisions which, in the past, have been made frequently by their employers, notably with respect to retirement planning.

The extraordinary growth in 401K defined contribution plans to the current level of approximately $480 billion in total assets is compelling evidence of this trend. Finally, the operating synergies between Mellon and Dreyfus, coupled with Mellon's well known technological capacity and expertise, virtually assure Mellon and Dreyfus customers of state-of-the-art products and services at competitive prices.

Consumer protection. Because we share your concern for depositor and investor protection, Mellon's policy statement on mutual funds previously provided to this subcommittee and other applicable policies and procedures go well beyond current bank practice and conform substantially to the requirements of H.R. 3447.

Our responses to earlier questions posed by this subcommittee, as well as our accompanying written statement, detail the many consumer protection provisions we have in place. In general, they are designed to ensure, first, that all of our employees who provide financial advice or sell mutual funds are well qualified and properly trained to discharge their responsibilities.

This includes a requirement that all employees of Mellon who recommend or sell mutual funds in Mellon Bank branches are registered with the National Association of Security Dealers and are, therefore, subject to NASD regulation. These duties range from determining the suitability of an investment for a particular customer to providing timely, accurate disclosures, and, second, that the investment risk, lack of deposit insurance and the distinction between bank deposits and mutual fund shares are disclosed to purchasers of mutual fund shares through the bank.

I would also emphasize that the Dreyfus name will be retained and that the Mellon name will not be used on any mutual funds. Bear in mind that separate from the statutory and regulatory requirements with which we must comply, our proactive stance on

consumer protection makes especially good business sense for us. We are, after all, a financial services company whose reputation and return to shareholders rests on our ability to attract and maintain long-term customer relationships.

When we announced this transaction in December, we said we need to make it a model that others could emulate in the future. The thorough employee training and consumer protections that we have created are the very foundation of that model.

A stronger Mellon Bank and Mellon Bank Corporation. Mellon Bank Corporation is today a diversified financial services company with a bank at its core. Our business strategy has been targeting this type of organization for the past 7 years because we believe it positions us well to compete in an industry that is changing profoundly.

The combination of Mellon and Dreyfus is not only a logical next step in pursuing that business strategy, but greatly strengthens both the corporation and Mellon Bank in several important ways. The transaction adds greater stability to Mellon's revenue base by bringing fee-based revenue which is known to be less volatile than interest revenue to 52 percent of our total revenue stream and it strengthens our balance sheet by improving significantly our capital ratios.

In addition, this fee-based income further strengthens the quality of our earnings. The transaction also builds on certain of Mellon's key strengths and past investments for the benefit of our customers. For example, it will utilize more effectively both our retail delivery system of more than 400 branch offices and our technological capacity and expertise, both long recognized strengths for Mellon.

In addition, the combined Mellon-Dreyfus will be the second largest investment advisory firm in the Nation, combining two firms with extensive experience and outstanding reputations in money management and customer service. This, in turn, will enable us to attract and keep the best investment and management expertise to such firms.

At the same time, Mellon has put into place a number of procedures and policies that are designed to ensure the safety and soundness of the bank. As detailed in our written submissions, they include commitments to apply sections 23(a) and 23(b) of the Federal Reserve Act to transactions between Mellon and Dreyfus and to refrain from a series of transactions that could create a conflict of interest.

Overall, the combination of Mellon and Dreyfus creates a new financial institution, stronger than either could be alone, one that, as to financial marketing and management capabilities, is uniquely able to meet changing consumer demands into the 21st Century.

In conclusion, it is important to remember as we consider this transaction that banks play a key role in the economic infrastructure of this Nation. Bank lending to consumers in small businesses and bank support of their local communities are unique and critical elements of a healthy U.S. economy.

But Mellon and other banks can continue to provide that essential economic fuel only if we are permitted to sell to consumers the services and products they need at times and places convenient to

them. To the extent that Mellon and Dreyfus are approaching this transaction with comprehensive protections in place for depositors and investors, and we believe we are doing so, this union of two great companies is a natural step in the reshaping of a financial services industry which must continue to evolve if it is to remain responsive to consumers' changing demands.

There are always potential risks in change. We believe we have accurately identified and analyzed those risks in this transaction and have in place the management expertise, operating capabilities and procedures to address them successfully. In the end, the much greater risk for our customers, our industry and our companies is to stand still when the environment in which we must compete is changing.

Thank you.

[Testimony resumes on p. 378.]

[The prepared statement of Mr. Cahouet follows:]

TESTIMONY OF FRANK V. CAHOUET

MELLON BANK CORPORATION

before
U.S. House of Representatives
Committee on Energy and Commerce
Subcommittee on Oversight and Investigations

concerning

Proposed Merger of The Dreyfus Corporation
with Mellon Bank, N.A.

INTRODUCTION

Three major industries in the United States are undergoing profound change at the present time: health care, telecommunications and financial services. All three industries have been shaped over the years both by economic and market forces, including consumer demands, and by legislative and regulatory initiatives. The Committee on Energy and Commerce is in the unique position today to shape the public policy which will help manage the changes occurring in all three industries.

Mellon Bank Corporation ("MBC") believes that fundamental change is best dealt with not by ignoring or resisting the change, but rather by managing the change through identification of the risks accompanying such change and the development of and implementation of techniques to manage those risks. We welcome the opportunity to work with the Committee to undertake such a process in connection with the risks that may be posed by one such fundamental aspect of change in the financial services industry; namely, the increasing affiliations between the banking

and mutual fund segments of the financial services market. MBC's proposed transaction with The Dreyfus Corporation ("Dreyfus") is a part of that change.

What MBC and Dreyfus have attempted to do is develop a model for dealing with this change. This model has five objectives, each of which must be accomplished if the model is to be successful: (1) worthwhile products for the consumer; (2) safety and soundness of both the bank and the mutual funds; (3) disclosure to enable the customer to make an informed decision; (4) minimization of conflicts of interest; and (5) benefits for both the constituent parties to the merger. In particular, MBC has developed an extensive Policy Statement on Mutual Funds (the "Policy Statement"), which is designed to build on its existing policies and procedures and those of Dreyfus, in order to accomplish these five objectives. In developing the Policy Statement, MBC has also attempted to address the issues and concerns in H.R. 3447, the Securities Regulatory Equality Act, H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act, and the banking agencies' guidelines on sales of nondeposit investment products.

After an overview of relevant changes in the financial services industry, this testimony is divided into eight sections which correspond to the topics listed in Chairman Dingell's letter of February 17, 1994: (a) the structure of the transaction;

(b) MBC's business reasons for the transaction; (c) required regulatory approvals; (d) post-merger regulation; (e) federal securities and banking law issues; (f) risk of depositor/investor confusion and the need for particular and focused disclosure; (g) conflicts of interest; and (h) legally enforceable safeguards.

CHANGES IN THE FINANCIAL SERVICES INDUSTRY

The transaction between MBC and Dreyfus takes place within the context of a generation of sweeping changes in the financial services sector and a steadily growing involvement of banks with mutual funds, precipitated in significant measure by changes in consumers' savings and investing patterns.

MBC believes that this transaction responds to consumer demand for a wider range of financial services easily accessed at convenient locations. It is also responsive to the massive outflow of bank deposits into mutual funds and to the relationship between increased fee income and the safety and soundness of the banking industry in the context of: slow growth in total bank loans; the demonstrated past impact of credit risk; and the volatility of interest rate margins.

By the end of 1980, there were 564 mutual funds with 11 million customer accounts and assets of $146.1 billion. Twelve years later, at the end of 1992, there were 3,848 mutual funds with 76

million customer accounts and assets of $1.7 trillion. During that 12-year period, mutual fund assets increased at an annual growth rate of 23 percent. At year-end 1993, in fact, new investments flowing into mutual funds were approaching new deposits in banks for the first time ever.

The growth in mutual funds has taken place to a large degree at the expense of bank deposits

While mutual fund assets have been growing at a dramatic 23 percent annual rate, bank deposits have been expanding at a much slower rate. Since 1980, bank deposits have grown at one-quarter the rate of mutual funds. Moreover, annual deposit growth has been at an even lower rate in the last five years, and non-interest-bearing deposits have declined sharply.

First Manhattan Consulting Group (FMCG), which advises many major United States banks, has analyzed the relative growth of bank deposits and mutual funds within the broader context of total household financial resources. Projecting to the year 2000 the various components of household financial resources, FMCG concluded that bank deposits will grow at 4 percent per year while mutual funds will grow at 15 percent per year.

The increased competition for traditional bank loans has created a greater need for bank fee income

Banks are, and are intended to be, a significant source of credit for households and businesses in the United States. Their unique role as supplier of credit to small businesses is especially important given the expectation that small businesses are expected to be the leading source of new jobs creation in the economic recovery.

Between 1980 and 1992, bank loans only modestly increased. This modest rate of growth took place within the context of rapid expansion of other credit facilities outside the banking industry. For example, the commercial paper market grew fourfold, from $124 billion at the end of 1980 to $531 billion at the end of 1991. Further, the credit risk involved in bank loans increased sharply during this period.

Banks involvement with mutual funds has increased

Until the mid 1980s, very few banks offered customers mutual funds or advised mutual funds. As a direct result, however, of the rapid growth in mutual funds, banks began to provide both services, frequently in conjunction, in order to meet their customers' needs.

At the end of 1993, Lipper Analytical Services, Inc. listed 1,256 bank-related mutual funds. The assets of bank-related mutual

funds now approximate $200 billion. Annex A lists more than 75 institutions that offer their own advised funds, so-called proprietary funds.

As the number of bank-advised mutual funds has expanded, so has the range of activities that banks perform in relation to those mutual funds.

In May, 1993, Wilmington Trust Co. became the first bank in the country to assume the role of "distributor" for its own mutual fund after receiving an opinion letter from the Federal Deposit Insurance Corp. expressing "no objection" to the action.

In November, the American Banker reported that "The boom in fund sales at banks over the past two years has accelerated many banks' development in the field, making marketing firms less important. .. big banks increasingly are choosing to manage investment-product sales programs on their own."

Earlier, in September, the American Banker reported that "administrators and distributors of bank-related mutual funds could face competition from their own clients: the biggest banks... Some banking giants [are] eyeing ways of doing more fund servicing in house." Banks cited in these and other articles included Bank America, Wells Fargo and Chase Manhattan Bank.

Thus, bank-related mutual funds--and the banks' performance of not only investment advice but a variety of other services for those mutual funds--is no longer a new or untried concept. It reflects the needs of consumers and the desire of banks to respond to those needs in the most efficient and effective way. And clearly, it continues to find growing acceptance among consumers who find attractive the ability to access mutual funds through their banks.

STRUCTURE OF THE MERGER

On December 6, 1993, MBC and Dreyfus announced that their respective boards of directors had unanimously adopted and approved a merger agreement. A copy of the merger agreement has been previously furnished to the Subcommittee. As a result of the merger, each share of common stock of Dreyfus will be converted into the right to receive 0.88017 shares of common stock of MBC. Closing of the merger is subject to approval of the shareholders of both Mellon and Dreyfus, certain regulatory approvals (discussed below) and approval of continuation of the investment advisory contracts by the directors and shareholders of the mutual funds advised by Dreyfus ("Dreyfus funds").

Pursuant to the merger agreement, a wholly-owned subsidiary of Mellon Bank will be merged with and into Dreyfus. Consequently, Dreyfus will be the surviving corporation in the merger and will

be a wholly-owned subsidiary of Mellon Bank, which is a wholly-owned subsidiary of MBC.

There are two basic reasons for establishing Dreyfus as a subsidiary of Mellon Bank, rather than as a subsidiary of MBC.

First, as a result of the proposed transaction, Mellon Bank's key capital ratios will increase by over 200 basis points. Moreover, Dreyfus' earnings will supplement Mellon Bank's earnings. A strong capital position and strong earnings not only enhance the safety and soundness of Mellon Bank and help ensure the highest rating under the capital-based requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991, but also promote higher ratings for Mellon Bank's deposits and other obligations.

Second, virtually all of MBC's retail activities are conducted through Mellon Bank and its subsidiaries. Positioning Dreyfus' largely retail activities as a subsidiary of the Bank will facilitate legal compliance, controls, product delivery and efficiency.

It should also be noted that MBC has voluntarily committed that all transactions between a Mellon bank and Dreyfus will be subject to Sections 23A and 23B of the Federal Reserve Act, even though these statutory provisions generally exempt transactions

between a bank and its subsidiaries. Those two sections are designed to ensure bank safety and soundness by imposing tight restrictions on extensions of credit and certain other transactions between a bank and its non-subsidiary affiliates and by requiring that all transactions between a bank and its non-subsidiary affiliates be conducted on an arm's length basis. MBC's voluntary commitment to apply Sections 23A and 23B, even though Dreyfus is to be a subsidiary of Mellon Bank, demonstrates MBC's commitment to safety and soundness.

STRATEGIC RATIONALE FOR THE TRANSACTION

There are three strategic imperatives which make this proposed merger especially attractive for both Mellon Bank customers and MBC shareholders:

<u>The transaction is responsive to consumer demands</u>

The transaction responds to consumer demands for a wider range of financial products and services conveniently offered by a single source provider. It also responds to the growing outflow of bank deposits into mutual funds as consumers make the shift from savers to investors. By responding proactively to these basic changes in consumers' financial behavior, Mellon Bank further solidifies its position as a leading financial institution by providing consumers with the services they want, and, thereby, significantly enhancing its ability to remain competitive in a changing industry environment.

<u>The transaction further stabilizes MBC's revenue stream</u>

This transaction will bring MBC's fee income to 52 percent of total revenue. As such, it is not only a furtherance of Mellon's stated business strategy but provides, as well, a prudent response to the changes in characteristics of the traditional banking industry.

For Mellon Bank, as for other banks, whole segments of the credit market have been lost to competitors, and loan growth has been sluggish at best. And as the credit loss experience of the mid- and late-eighties demonstrated all too clearly, taking on credit risk in order to garner a greater share of credit volume is not a viable remedy for reduced revenues. Fee income, in contrast, significantly increases return on equity and assets; provides, through diversity, a more stable revenue stream; and enables Mellon Bank to better support the risk to which it is exposed in its lending function by insulating a greater share of its revenue stream from market volatility. So clear, in fact, are the advantages to a bank of expanding fee-based income that, increasingly, the banking organizations that have a sizeable fee income component are recognized and rewarded by the capital markets.

The Mellon/Dreyfus transaction builds upon certain of Mellon's key strengths

The combining of the Dreyfus and Mellon Bank organizations builds upon certain of Mellon's Bank key strengths and past investments. MBC, already a leading investment advisory firm in the country, will rank second among such firms in the nation once the transaction is completed. This leadership position translates to an ability to attract on behalf of customers the best investment and management expertise available to such firms.

The retail-oriented nature of Dreyfus' business enables Mellon Bank to utilize even more productively the product delivery capacity represented by its approximately 450 branches in three states --Pennsylvania, Delaware and Maryland. In broadening its array of product offerings through its branch franchise, while increasing the efficiency of its delivery system, Mellon Bank can improve service to customers and increase profitability materially as a result of the transaction.

The addition of Dreyfus' business also complements MBC's strength as a technology leader by further building upon MBC's considerable investment in technological capacity and capabilities. This aspect of the transaction better positions Mellon Bank to improve both customer service through state-of-the-art product offerings and to improve profitability in

technology-related products and activities, while maintaining prices at competitive levels.

Recently, MBC was ranked No. 2 by Computerworld magazine among the nation's top corporate users of technology. This technological experience, expertise and capacity, when applied to the proposed transaction with Dreyfus, will produce operating economies which virtually assure customers of both Mellon and Dreyfus of continued high-quality, innovative products and services at low cost to the consumer.

REGULATORY APPROVALS

Consummation of the merger is conditioned on receipt of approvals of the merger by various governmental regulatory agencies, including the Office of the Comptroller of the Currency ("OCC"). Mellon Bank filed a Notice of its intention to acquire Dreyfus as an operating subsidiary of Mellon Bank with the OCC on December 30, 1993 (the "OCC Notice"). In addition, MBC has filed applications with the Board of Governors of the Federal Reserve System for approval to acquire certain subsidiaries of Dreyfus and with the Office of Thrift Supervision for approval to acquire Dreyfus Security Savings Bank, a federal savings bank. MBC will file an application with the New York State Department of Banking for approval to acquire Dreyfus Trust Company, a New York trust company. MBC and Dreyfus have each filed notices under the Hart-Scott-Rodino Antitrust Act with the Department of Justice and the

Federal Trade Commission. The agencies have concluded their premerger review of the transaction and have terminated the waiting period under the Act.

POST-MERGER REGULATION

Dreyfus will be maintained as a separate corporate entity. Accordingly, it will continue to be registered as an investment adviser and subject to regulation by the SEC under the Investment Advisers Act of 1940. Its registered broker-dealer subsidiary, Dreyfus Service Corporation, will remain registered as a broker-dealer with and subject to regulation by the Securities and Exchange Commission under the Securities Exchange Act of 1934. These commitments were contemplated by the OCC Notice and will be added as specific provisions to the Policy Statement. These commitments are also consistent with Section 104 of H.R. 3447. Further, to address concerns about Dreyfus' capital, MBC will amend the Policy Statement to provide that it will not withdraw capital if such withdrawal would jeopardize Dreyfus' ability to maintain regulatory capital compliance.

In addition, Dreyfus and its subsidiaries would be subject to regulation by the OCC as operating subsidiaries of national banks. In particular, the OCC will be responsible for enforcing compliance with the terms and conditions of any order approving the transaction, including commitments made in the Mellon Policy Statement.

FEDERAL SECURITIES AND BANKING LAW ISSUES

Securities Laws

As discussed above, Dreyfus and DSC will continue to be subject, respectively to the Investment Advisers Act and the Securities Exchange Act. We believe that we have been responsive to the concerns over certain other aspects of the federal securities laws which are reflected in H.R. 3447.

Banking Laws

Before pursuing the Dreyfus transaction, Mellon reviewed with counsel the legal authority for the transaction and, in particular, whether there would be a violation of the Glass-Steagall Act.

The Notice filed with the OCC was accompanied by a legal memorandum which presents Mellon's position that the proposed transaction is consistent with law and regulation. As pointed out in that memorandum, the activities in which Dreyfus will be engaged after the transaction have previously been approved by the OCC for national bank subsidiaries and are offered by scores of banks around the country.

RISK OF DEPOSITOR/INVESTOR CONFUSION

Customer Disclosures

MBC shares the concerns that the Chairman and other members of this Subcommittee have expressed regarding depositor and investor

protection, including the need to make customers aware of the distinction between bank deposits and mutual fund shares. Mellon Bank's basic philosophy with respect to disclosures to customers as to mutual funds and other investment products reflects the premise of the federal securities laws in regulating securities activities: ensuring the protection of investors through full disclosure concerning securities sold and the prevention of unfair and inequitable practices in the securities market. We believe that both the timing and content of our disclosures to consumers concerning mutual funds will ensure that this philosophy is realized.

First, no MBC entity, including Dreyfus after the merger, will sell shares of a mutual fund or advise a mutual fund if such fund has a name, title or logo of Mellon Bank or any other banking subsidiary of MBC (a "Mellon bank") or is so similar to such a name, title or logo as to be confusing to customers. This commitment appears in the Policy Statement, and it goes significantly beyond other banks competing in the mutual fund business today which continue to use a bank name in the name of an affiliated mutual fund.

Second, Mellon Bank customers receive disclosures concerning the possible risks of purchasing mutual funds which will be in full compliance with all regulatory guidelines, including the recently-released Interagency Statement on Retail Sales of

Nondeposit Investment Products of the OCC, Federal Reserve, FDIC, and OTS. As set forth in the Policy Statement, the following disclosures will be made to customers who purchase shares of a mutual fund at a Mellon bank branch office or who open an investment or similar account with any MBC entity (including Dreyfus) at a Mellon bank branch office through which he or she can make such purchases:

1. That the shares are not insured by and are not an obligation of the FDIC or any other government agency;
2. That the shares are not a deposit or other obligation of and are not endorsed or guaranteed by any Mellon bank or any other bank;
3. That the investment poses investment risks, including possible loss of the principal amount invested, and that the investment may fluctuate in value sc that when the investment is sold by the customer it may be worth more or less than when purchased by the customer;
4. To the extent applicable, that there exists an investment adviser relationship between an MBC entity and the mutual fund, and a statement that MBC entities may have other types of relationships (such as custodian or transfer agent) with the mutual fund; and
5. That, if applicable, there are sales charges to which the shares may be subject.

Customers receive disclosures covering the critical differences between mutual funds and bank deposits on at least four and as many as five occasions: First, Mellon bank branches have graphic disclosure signs on their doors and prominently displayed at multiple locations within the branches themselves (a copy of such signs have previously been furnished to the Subcommittee). Second, any customer discussing uninsured investment products with a branch employee is shown and read a disclosure card (copy previously furnished to the Subcommittee). Third, customers establishing brokerage accounts with MBC's registered broker-dealer, InvestNet, or receiving applications to purchase proprietary funds directly from their distributor sign a disclosure form acknowledging receipt of disclosures (copy previously furnished to the Subcommittee). Fourth, the prospectuses for all funds sold will themselves contain the disclosures. Finally, any customer meeting with a registered representative receives oral disclosures from the representative and is encouraged to discuss them with the representative.

POTENTIAL CONFLICTS OF INTEREST

MBC recognizes that it is prudent public policy to ensure that consumers of mutual fund and other investment products offered by or through financial service companies (including banks), and banks themselves, are protected against potential conflicts of interest which might arise from the fact that the companies offer a variety of services to customers. We believe that MBC has

provided these protections both through existing internal policies and procedures as well as through the Policy Statement. We also note that the Investment Company Act of 1940, as well as other federal securities laws, provide an extensive array of protections for mutual fund shareholders from potential conflicts of interest. The following is a summary of the principal conflicts of interest identified by MBC and MBC's plans to deal with them.

Trading on Material Nonpublic Information

MBC has adopted extensive policies and procedures to prevent the misuse of material nonpublic information by MBC, Mellon Bank and their subsidiaries and affiliates, which misuse is prohibited by the Investment Company Act of 1940, as well as by the Securities Exchange Act of 1934. These policies and procedures are designed, among other things, to limit access to material nonpublic information. A copy of MBC's Confidential Information and Securities Trading Policy (the "MBC Securities Trading Policy") has previously been furnished to the Subcommittee. The MBC Securities Trading Policy will be incorporated by reference into the Policy Statement.

In addition, Dreyfus has extensive policies and procedures designed to prevent the misuse of material nonpublic information, which are codified in a Code of Ethics (a copy of which has previously been furnished to the Subcommittee). Use of material

nonpublic information in the possession of a Mellon bank by any Dreyfus or Dreyfus Fund would be strictly prohibited by both the Mellon Securities Trading Policy and the Dreyfus Code of Ethics.

Sharing of Customer Information

We recognize that there is concern about unauthorized sharing of customer information, and we have attempted to deal with that issue by providing in the Policy Statement that no Mellon bank will share confidential customer information with any MBC entity (including Dreyfus after the merger), other than (a) pursuant to the customer's consent or (b) information of a type that the MBC entity could receive in a credit bureau or similar report.

Independence of Mutual Funds

In order to reduce the potential for conflicts of interest, MBC has voluntarily committed in the Policy Statement to ensure the independence of any mutual fund advised by any MBC entity, including the Dreyfus Funds after the merger ("Mellon-Advised Funds"). These commitments go beyond those which are already in place in the Investment Company Act of 1940, and are consistent with the provisions of H.R. 3447. In particular, no director, officer or employee of an MBC entity will serve as a director of any Mellon-Advised Fund, and MBC has committed in the Policy Statement not to control a Mellon-Advised Fund in any other manner, including by reason of owning in a fiduciary capacity with the power to vote more than 25% of the shares of a Mellon-

Advised Fund. This commitment is consistent with the purposes behind Section 113 of H.R. 3447.

Restrictions on Certain Transactions with Mellon-Advised Funds

MBC has identified in the Policy Statement certain transactions which might pose conflicts of interest. In order to ensure the safety and soundness of the banking system, MBC has voluntarily restricted such transactions. Similar "firewalls" appear in H.R. 3447, and are aimed at minimizing concerns over conflicts of interest and other so-called "subtle hazards."

Among the transactions which have been voluntarily restricted in the Policy Statement so as to avoid potential conflicts of interest are: (a) loans between an MBC entity and a Mellon-Advised Fund; (b) purchases by an MBC entity for its own account from, or sales of portfolio securities from its own account to, a Mellon-Advised Fund; (c) sales of securities to a Mellon-Advised Fund which are being underwritten or placed by an MBC entity; (d) purchases by a Mellon-Advised Fund of securities in the process of issuance if an employee in an MBC entity advising such Fund has actual knowledge that the proceeds of an issuance of securities will be used to retire indebtedness to an MBC entity; and (e) purchases by an MBC entity for any third party account over which it has discretionary authority of a security issued by a Mellon-Advised Fund.

Compensation of Sales Personnel

Mellon Bank's compensation structure for branch personnel is specifically designed so as not to provide a financial incentive to sell specific investment products. Indeed, Mellon Bank does not pay branch personnel on a per-item basis for any financial service or product which is referred or sold. This procedure is in contrast to a number of banks which pay a specific fee to branch personnel for referrals to an investment sales area.

LEGALLY ENFORCEABLE SAFEGUARDS

MBC fully intends to abide by the spirit as well as the letter of the commitments made in the Policy Statement. Accordingly, we are willing to have the commitments set forth therein converted into conditions of regulatory approval should the OCC so desire. We have also committed to prior notice to the OCC of any change in the Policy Statement in order to ensure that Mellon Bank remained in compliance with the terms of the OCC's approval order. We would emphasize that MBC's Policy Statement goes beyond current law and is consistent in purposes with H.R. 3447.

In particular, MBC anticipates that application of Sections 23A and 23B to transactions between Mellon Bank and Dreyfus, as provided for in the Policy Statement, would also be incorporated as a condition of any approval of the merger (if granted) by the OCC. Accordingly, the OCC would examine for, and enforce compliance with, these two sections to the same extent as the OCC examines for and enforces compliance with these two sections in the context of national bank transactions with affiliates other than operating subsidiaries.

Annex A

BANKING ORGANIZATIONS THAT OFFER PROPRIETARY MUTUAL FUNDS

Amcore Bank

AmSouth Bancorporation

BancOhio National Bank

BancOklahoma Trust

BancOne

Bank of America

Bank of Boston Corp.

Bank of California

Bank of New York Co., Inc.

Bankers Trust Co.

BayBanks Inc.

Bessemer Group, Inc.

Boatmen's Bancshares, Inc.

Boulevard Bank

Branch Banking & Trust Co.

Brown Brothers Harriman & Co.

Central Bancshares of the South, Inc.

Central Carolina Bank & Trust Co.

Central Fidelity Banks, Inc.

Chase Manhattan Corporation

Chemical Banking Corporation

Citicorp

Comerica, Inc.

Commercial National Bank

Compass Bank

CoreStates Financial Corp.

Crestar Financial Corp.

Deutsche Bank, AG

Fifth Third Bancorp

First Alabama Bancshares, Inc.

First Fidelity Bancorporation

First Interstate Bancorp

First Michigan Bank

First Bank System, Inc.

First National Bank of Chicago

First National Bank of Omaha

First National Bank of Wichita

First of America Bank Corp.

First Union Corp.

Firstar Corp.

Fleet/Norstar

Great Western Financial Corp.

Harris Bankcorp, Inc.

Hibernia Corp.

Huntington Bancshares, Inc.

LaSalle National Corp.

Liberty National Bancorp, Inc.

Mark Twain Bank

Marshall & Ilsley Corp.

Mellon Bank Corp.

Mercantile Bancorporation, Inc.

Midlantic Banks, Inc.

Morgan Guaranty Trust Co.

National Bank of Commerce

National Bank of Detroit

NationsBank Corp.

Northern Trust Corp.

Norwest Financial Services, Inc.

Old Kent Financial Corp.

PNC Financial Corp.

Premier Bancorp, Inc.

Provident National Bank

Riggs National Corp.

Seattle First National Bank

Security Financial Corp.

Shawmut National Corp.

Signet Banking Corporation

Society Corp.

South Carolina National Bank

Star Banc Corp.

State Street Boston Corp.

SunBank

Trustmark Corp.

United Jersey Bank

United Missouri Bancshares, Inc.

United States Trust Company

Valley National Bank

Wachovia Corp.

Washington Mutual Savings Bank

Wells Fargo & Company

Wilmington Trust Corp.

Mr. DINGELL. Thank you, Mr. Cahouet. Mr. Stein.

TESTIMONY OF HOWARD STEIN

Mr. STEIN. Mr. Chairman and members of the subcommittee, I am pleased both to respond to your questions and have the opportunity to discuss our merger with Mellon. How the participants in this transaction approach this matter, we believe, could well set the standard not only for this century's future, but the standard by which the savings and investing public's legitimate demands will be met.

There are issues here that we are anxious to discuss and I appear before you fully committed to the soundness of the transaction and the need to enter it in a way that will enhance public policy, as well as the economic vitality of the operations involved.

In my testimony today, there are three basic touchstones, one personal to myself, one dealing with the strongly held regulatory views, and one regarding the future of our industry that I know we and our colleagues at Mellon share.

First, I joined with Jack Dreyfus nearly 40 years ago to help create and build a mutual fund organization that, while hopefully successful, would reflect our shared values and sense of obligation to the public values that were perhaps more commonly held in the immediate post-war era than later. It was, we felt, key to whatever success we could achieve that Dreyfus' name, its reputation for prudence, conservative money management, and total integrity in all aspects of its business were embedded in the public's mind. Without that, the attempt to attain the fundamental goal of the Dreyfus Corporation, bringing the financial benefits to the many once reserved only for the few through mutual funds, would be in vain.

I think it is fair to say, Mr. Chairman, that since our beginning in the 1950's, the Dreyfus name has achieved some national recognition, earned a reputation for soundness, stability, strong corporate citizenship, and brought the necessary financial rewards to its stockholders. I stress this only to make the point that the people and culture of the Dreyfus Corporation hold the same values today and would not undertake any new direction that could possibly jeopardize our hard-earned respect of 40 years.

Second, while I would defer to the subcommittee and Congress at large on general matters of public policy, I retain for myself deeply held views on the need for regulatory protection of the public in my own industry. The Dreyfus Corporation and I have lived our entire business lives within the rules and regulations promulgated under appropriate laws by the Securities and Exchange Commission. I have not found this in any way burdensome, but totally appropriate, indeed helpful, in the public's growing acceptance and reliance on mutual funds as a reliable investment vehicle.

In fact, from time to time, I have been outspoken within the industry, as well as in public, concerning the need for even greater regulatory watchfulness by the SEC and for larger resources to be put at their disposal by Congress to better accomplish this work. It was perhaps the depth of my views on such regulatory matters in general that resulted in my appointment to the Presidential

Task Force on Market Mechanisms, the Brady Commission, following the market break of October 1987.

Mr. Chairman, we at Dreyfus firmly believe that an essential element in the success of mutual funds has been comprehensive, strict and uniform regulation of the industry, primarily, of course, by the SEC. Because of the existing well developed scheme if disclosure, the mutual fund industry has prospered under the bright light of full and accurate investor information. Moreover, investors justifiably have confidence in an industry that because of effective regulation has been virtually untainted by scandals and failures despite its rapid growth and great size. It is vital that this regulatory structure not be disrupted and, further, that it be carefully adopted to bank participation in mutual funds. That is why we strongly support the core principles of the Dingell-Markey functional regulation bill and why Mellon and Dreyfus have committed to operating Dreyfus as an entity that will continue to be fully subject to SEC regulation.

Third, our Nation and economy is known throughout the world for its many attributes, not the least of which is its openness and accommodation to change. Whether in social or economic policy, that inclination has been marked by a unique mixture of adaptation to the demands of the future, tempered by retaining the best of the proven past.

What is true for the economy at large holds for the financial services industry, as well. If we cannot adapt to the competitive demands as we see them shaping for the future, if we cannot alter our relationships for the benefit of the investing public, our industry will not meets its promise, but we can and should do so only, as I have stated, under a sound and strong regulatory environment, coupled with a corporate commitment to total integrity; in other words, change bringing the best of the past with us.

And we at Dreyfus have always sought progress. Much as we were key in the creation of tax-free investing, key in the establishment of money market funds, with the finest attention to regulatory requirements to safeguard the investor, we propose to move forward once again believing that the growing complexity of the marketplace, the explosive growth in numbers of mutual funds available to the public through innovative channels of distribution, we recognize the future of financial services as we saw it and responded to it. That recognition, simply stated, was that two organizations that had played so prominent a role in our Nation's financial history, Mellon and Dreyfus, would be uniquely positioned to meet the public's growing desire for an array of high quality financial products delivered by a source committed to impeccable standards.

It is clear to us and to our colleagues at Mellon, as well, to expert observers of the field, that in the financial world, significant change was in the air and it required innovation and real leadership to react. But it was also clear to us that if we were to succeed, it would only result if we could set high standards for the industry, only if we and Mellon adopted standards of conduct that would not only satisfy current regulatory requirements, anticipate possible future requirements, and, of equal importance, satisfy ourselves as

people that by so doing, we would achieve greater acceptance with our customers through enhanced competence and integrity.

We have submitted this policy statement, as well as other pertinent documents, to the subcommittee concerning the business and regulatory aspects of the merger.

Mr. DINGELL. Thank you, Mr. Stein. Mr. DiMartino or Mr. McGuinn, do you have any comments you'd like to add?

[No response.]

Mr. DINGELL. Gentlemen, the Chair has got to adjourn this meeting for 30 minutes. I will return immediately thereafter. You have my apologies for this. Before I do depart, I want to thank you both, gentlemen, for a very fine statement and I will return in exactly 30 minutes. Thank you very much for your courtesy. Then we will have the questions at that time.

[Brief recess.]

Mr. DINGELL. The subcommittee will come to order.

Mr. Cahouet, if the proposed merger between Mellon and Dreyfus goes through, amongst other things that will happen, Mellon Bank will be selling Dreyfus funds out of Mellon Bank's locations. It is my understanding that Mellon recognizes the potential confusion this will create in the eyes of bank consumers.

Tell me what your plan is to ensure that Mellon Bank customers don't infer that Mellon Bank protection such as FDIC insurance will now cover Dreyfus mutual funds.

Mr. CAHOUET. Mr. Chairman, with your permission, I would like to ask Mr. McGuinn, who is in charge of the retail operation, and that is through which we will be selling those funds, if he would respond to that.

Mr. DINGELL. That would be just fine.

Mr. McGuinn.

Mr. MCGUINN. Yes, sir. Let me describe, if I may, exactly how it would work if a customer came into one of our branches and inquired about a mutual fund.

First of all, we have on the doors to all of our branches a sign which makes it perfectly clear that while we have investment products, these products are not FDIC insured, the products involve investment risk, including the possible loss of principal. In fact, you can get back more or less than you originally invested. That they are not guaranteed by Mellon Bank or any bank, and that these products are not deposits for bank accounts.

Mr. DINGELL. Very well. Without objection, we will insert that in the record.

[The information follows:]

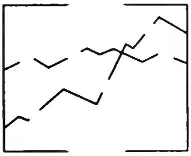
Investment Products

Investment products such as mutual funds, annuities, stocks and bonds are appropriate for many individuals. If you are interested in any of these products, we can help you. InvestNet® Corporation – Mellon's brokerage affiliate – can make a wide variety of investment options available to you.

We want you to understand a few basic facts about investment products, wherever you buy them:

These products are **not** FDIC-insured.

These products involve investment risks, including the possible loss of principal – you may get back more or less than you originally invested.



These products are **not** guaranteed by Mellon Bank or any other bank.

These products are **not** deposits or bank accounts.

We would like to help you with your investment needs. Please ask us.

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Mr. McGUINN. When the customer would continue on into the branch, he or she really has a choice. If he or she went up to one of the tellers and inquired about a noninsured investment product, our tellers are strictly prohibited from either making any sales, of course, or even more importantly rendering any advice, so they would refer that person over to our platform area where they would talk to a customer service representative. That customer service representative, if the person knew the mutual fund that they wanted to buy would help them open an account with our InvestNet which is a broker-dealer affiliate of Mellon Bank. By the way, that is registered with the SEC and it is a member of the NASD. Then they could go ahead and purchase that mutual fund without any advice through InvestNet.

If they wanted some investment advice, we have professional investment consultants who are, again, licensed and trained consistent with NASD rules, and they are also employees not of Mellon Bank but rather of InvestNet, which is that SEC-registered broker-dealer.

We have about 60 PIC's, as we call them, and if a PIC happened to be in the branch, that would be terrific and an appointment could be set up. If not, an appointment would be set up with that PIC and the PIC would meet with the person either at their home or office or in that or some other branch which might be convenient.

Mr. DINGELL. Mr. McGuinn, just to help us, what is a PIC?

Mr. McGUINN. I am sorry, I thought I said personal investment consultant first, excuse me.

Mr. DINGELL. OK, because we got a new word and I thought, oh boy, what is this. Go ahead.

Mr. McGUINN. It is an affectionate acronym for us. But these personal investment consultants, or PIC's, are trained and licensed as part of the NASD and employees of InvestNet which is very important for us.

Then when they met with the PIC, if they were seeking investment advice, the PIC would go through a complete suitability analysis with that particular customer, talking about their financial profile, their investment needs, their appetite for risk, and so forth, and based on that suitability analysis which the customer would be asked to review and then sign—by the way, in that suitability analysis, in addition to all the suitability issues, all the disclosures are, again, repeated that I just mentioned, so the customer would then be asked to sign both the suitability analysis as well as acknowledgment of those disclosures. At that point, the PIC would go ahead and render the advice.

In our branches, by the way, we also have this kind of sign which is very similar to what you just saw on the decal on the doors to all of our branches, which also are at both the teller windows as well as on the customer service representative desks. If an InvestNet PIC should meet in the branch with one of these customers, it actually would be designated with a sign that says "InvestNet" and include these disclosures as well.

So any customer, to summarize, who really comes into our branches and seeks to buy a mutual fund will probably encounter,

either orally or in writing, three to five times, this complete panoply of disclosures.

Mr. DINGELL. Now, Mr. Stein—the Chair is going to withhold.

Does someone from the committee have questions?

Mr. SCHAEFER. Thank you, Mr. Chairman, and I appreciate the gentleman being here today. I know you had a long wait. We had some important things to get out of the way first, as you well knew. I also am pleased that you are supporting 3447. For the chairman's benefit, I am cosponsoring this particular bill today myself because I think it is a necessary guarantee and guard that we have to have in light of the Keating, American Continental situation.

Mr. DINGELL. By the way, would the gentleman yield?

Mr. SCHAEFER. Yes.

Mr. DINGELL. The Chair would like to thank the gentleman for those comments.

Mr. SCHAEFER. I am pleased to do it, sir.

All right. Now I am understanding that you are willing then to embrace the safeguards that are outlined in 3447. As I understand from your comments, Mr. McGuinn, and Mr. Cahouet said in his testimony that the Dreyfus name is the one that is going to be used, and it is not going to be Mellon and Dreyfus, it is Dreyfus on the mutual funds, et cetera. Am I correct?

Mr. CAHOUET. Mr. Congressman, you are correct in regard to the Dreyfus mutual funds. We also have a family of funds called the Laurel Funds, and we will continue to use the Laurel Fund. But in regard to the Dreyfus fund, you will not see Mellon Bank's name attached to the Dreyfus fund. You will not see Mellon's logo attached to the Dreyfus fund. The Dreyfus funds will be marketed completely separately, and that will be the way it will be done.

Mr. SCHAEFER. Yes. Of course, that was one of the big problems we had with Keating and the other two organizations.

The same is true then, as I understand, Mr. McGuinn, with the logos?

Mr. MCGUINN. Yes, sir. But I should——

Mr. SCHAEFER. There is a difference between a Mellon logo and a Dreyfus logo?

Mr. MCGUINN. Yes, sir, there is. But I should explain when, as Mr. Cahouet mentioned, that we sell a variety of mutual funds now through the PIC's as I was described.

Mr. SCHAEFER. Yes, sir. I understand.

Mr. MCGUINN. But even before we had discussions with Dreyfus, one of the funds that we sell is a Dreyfus fund with a number of other funds, not only our Laurel and Boston Company funds, and it is the Dreyfus funds that would be sold separately by Dreyfus that was referred to.

Mr. SCHAEFER. What about the disclosures that inform the customers that the funds, mutual funds, sold by the bank are not FDIC insured, what procedures are you going to be adopting to show adequate disclosures that these are not FDIC insured?

Anyone who would like to answer?

Mr. MCGUINN. If these mutual funds are being sold through our PIC's because people want investment advice and the meetings are taking place in the branches, it would be the whole series of disclo-

sures I mentioned before, from the door to the teller to the customer service representative area to the written forms which are reviewed with the customer and actually acknowledged in writing.

If people come into our InvestNet subsidiary or order by the phone, there is no investment advice given, but the acknowledgements that they receive indicate that none of these investment products are either FDIC insured or those series of disclosures which I mentioned before.

Mr. CAHOUET. If I could add, Congressman, we currently are selling through the branches where we are providing investment advice, we are currently selling today 30 different funds. It happens that one of the funds today is a Dreyfus fund, but we have a full range of funds in order to accommodate the various needs of our customer.

Mr. SCHAEFER. I fully understand that. I know that it is not just Dreyfus. Tell me about suitability standards, how are you going to assure that the bank personnel recommend a suitable investment?

Mr. MCGUINN. We have, first of all, training for all of our PIC's, if I may continue to refer to them that way, and remember that, again, these are licensed under the NASD rules. We prefer that they all have a Series 7 license, some have a Series 6. But in order for anybody to be a PIC, they must be licensed. Again, remember they are employees of InvestNet, which is an SEC registered company.

We have, in addition to all that licensing and training procedures, an actual client profile and asset allocation worksheet which is printed, and then we ask that our PIC's work through with the clients, both in order to get the information from them and also to make sure that they give the necessary disclosures to them, and then to have the customer acknowledge those in writing.

By the way, we follow-up on many of these, too. I mean, all of these suitability analyses are checked by principals of InvestNet. We follow-up with customer interviews to make sure that they did receive the various disclosures and understood them, importantly, and we do a number of customer surveys and even mystery shopping, so that this really is a full-cycle process.

Mr. SCHAEFER. Is there any chance—I know it is probably a hypothetical—that a licensed investment counselor, seller, would somewhere along the line be a teller?

Mr. MCGUINN. No, sir. I mean maybe in the past history.

Mr. SCHAEFER. I know the money is not there, I understand that. That is a big difference.

Mr. MCGUINN. No, an InvestNet licensed PIC could not also be a teller. In fact, our tellers are strictly prohibited from rendering any investment advice or selling any mutual funds or other securities.

Mr. CAHOUET. You might mention the compensation arrangement, too.

Mr. SCHAEFER. Yes, I was going to get to that anyway.

Mr. MCGUINN. Well, our PIC's are compensated both with a base salary as well as a compensation which is less than the base salary, and the commission compensation is less than the base salary and is also capped.

Mr. SCHAEFER. Have you ever had any—well, you wouldn't have had. We try to keep thinking of all these things that are going to put a stop to any collusion in the past, but what about the possibility of a teller working with one of your PIC's out there and getting reverse compensation for sending somebody over there, any chance of something like that happening? I don't know how we could stop it.

Mr. MCGUINN. Well, we certainly in our training and in all of our procedures seek to prevent that, and I can assure you, though, that our tellers who may refer, as I pointed out before, customers over to a customer service representative who could set up an appointment with a PIC, but our tellers are not in any way compensated for sales of mutual funds.

Mr. SCHAEFER. But there are cases probably where a former teller could become a licensed PIC?

Mr. MCGUINN. Yes, sir, if they go through the training and then receive the license.

Mr. SCHAEFER. Mr. Chairman, I will yield back for right now and see what I have else for questions.

Mr. DINGELL. The Chair thanks the gentleman.

Mr. Stein, you will recall the questioning of Mr. Cahouet. In addition to the sales in the bank lobby, Dreyfus will be, of course, continuing to sell mutual funds through cold calls over the phone, advertisement, brochures, and so forth. What disclosures will be incorporated into these marketing techniques to ensure that potential purchasers of Dreyfus mutual funds won't infer Mellon Bank protections because either they are, one, independently knowing that Dreyfus is now part of Mellon Bank or, two, because your sales/purchase persons in some way might have unfortunately made the Mellon-Dreyfus link?

Mr. STEIN. Mr. Chairman, would it be all right to have Mr. DiMartino address that question?

Mr. DIMARTINO. Mr. Chairman, in the statement of policy that was released or submitted to the committee, there was an outline of the selling mechanism that would take place within the banking system and the banking premises.

With respect to the selling mechanism that Dreyfus has, because of its own brand name, we feel that the NASD and the SEC presently cover our selling mechanisms, and if there were any concerns about that that would come from any of the regulators, we would address those concerns when they would come from the regulators.

Mr. DINGELL. Thank you.

Mr. Stein, let's assume one of my constituents in Michigan, again dear old Widow Goodbody has watched CNN or read the Wall Street Journal, now if and when the deal here that we are discussing goes through, the Widow Goodbody will know that Dreyfus mutual funds are now a subsidiary of the Mellon Bank. Based on the information we heard yesterday, when people make the connection between a bank and a mutual fund company, they tend to believe that the protections of the bank extend to mutual funds.

Now, on whom is the burden in the time subsequent to the Mellon-Dreyfus merger to warn any and all potential customers through advertisements, brochures, or other solicitations that Drey-

fus mutual funds are no way more secure because of the bank merger with Mellon?

Mr. STEIN. Well, in the case of the Widow, I think we are waiting for the comments by the regulatory group, and we are willing to work with them, obviously, in terms of what is best to remove any of the confusions, and wee have worked always with the SEC on various issues. As soon as those comments become available from the regulatory bodies, we will begin to work out how it is handled on our side.

Mr. DINGELL. Now, Mr. Stein, Mellon and Dreyfus have both made a number of voluntary commitments in the submissions which you have made to the OCC. They, by the way, do you a great deal of credit. Is it your intention to abide by all of these commitments?

Mr. STEIN. Yes, we will.

Mr. DINGELL. I assume you join in that feeling, Mr. Cahouet?

Mr. CAHOUET. Absolutely.

Mr. DINGELL. Now, Mr. Stein, will any cross marketing take place between Dreyfus and Mellon Bank? For example, will individuals making solicitation on behalf of Dreyfus mutual funds have access to the bank records of Mellon clients?

Mr. STEIN. No, that is not the way in which it will work. If the banks, for example, have mortgages that they can make available to our constituency—we have our own little mortgage operation now, but we can handle it on a large scale, but we will be bringing the mortgage possibilities to our customers and mail out and let them know that we have them available. Through that process, which is operated on the phone, we think we will be able to deliver a very effective and good mortgage.

Mr. DINGELL. In other words, you would let them know that you have those funds available, but you would not have them made available to you for solicitation nor would the solicitation take place, for example, in the bank lobby or in some fashion like that; is that what you are telling me?

Mr. STEIN. That's right.

Mr. DINGELL. Now, will salespersons be giving individuals slips so that they can solicit mutual fund business?

Mr. STEIN. No, we do not plan on that.

Mr. DINGELL. Now, Mr. Cahouet, back to the consumer protection within the Mellon Bank lobby, the subcommittee received testimony yesterday that confusion in bank lobbies is rampant regarding whether mutual funds are afforded protection of FDIC insurance and also to the extent SIPC protects them from losses. With the program that you will be proposing, how low do you think your rate of confusion will be?

Mr. CAHOUET. Well, Mr. Chairman, we hope it gets down to zero, and we will drive in that direction. Our effort, and I think that you can certainly see it from our opening statements, is to do the best possible job that we can for our customers, and our objective will be to drive it to zero.

Mr. DINGELL. Mr. Stein, in your statement, you said, and I quote now, "Mellon-Dreyfus would be uniquely positioned to meet the public's growing desire for an array of high quality financial products delivered by a source committed to impeccable standards."

Mr. Cahouet, what I am trying to understand here is exactly what those standards are. After the efforts that you have described today, do you find that 1 in 10 of the customers to whom your employees have sold mutual funds through the bank failed to understand, one, the fees associated with these funds; two, the risk associated with their principal; three, that FDIC insurance wouldn't apply; or, four, that SIPC provides a totally different kind of protection than FDIC insurance? How does that relate to your commitment to impeccable standards in your testimony, and what would you do with regard to the sale of mutual funds through the bank if you found that you had a high confusion level on these points?

Mr. CAHOUET. Well, Mr. Chairman, if I understand the question correctly, if 10 percent of the people that buy mutual funds through our organization are confused, we would not be satisfied in any sense. We would try and find out why they are confused, and it might be a system problem and we would try to get at it and solve it.

Mr. DINGELL. Mr. Cahouet, the constant theme we heard yesterday from the prosecutors in the Lincoln case, and from consumer protection groups was that customers of the bank, such as your customers at Mellon Bank, have established a relationship and a trust over the years with the bank. Moreover, disclaimers, prospectuses and the signing of statements saying they understand the mechanics of the transaction are far less significant and, indeed, have often been found to be meaningless when compared to the conversation they have with tellers and marketing people.

Now, what kind of a system would you and Mr. Stein put in place so that you can independently assess and evaluate the day-to-day sales pitches that your employees are giving to the customer?

Mr. CAHOUET. If I understand Lincoln, and you are talking about the Charles Keating situation in the savings and loan situation, if I understand that correctly, of course, that was selling securities of the company, themselves, whether debt securities or equity securities and, of course, we can't sell that at the branch level because we can't distribute our own securities.

But how would we assess how effectively we are being, we would probably do it in forms of mystery shopping. We would certainly do it in going back and asking a representative number of customers whether they were confused or whether they weren't confused. It is in our own best interest to make sure that we do an excellent job for our customers.

Mr. DINGELL. I gather that you are describing a phenomenon of using somebody kind of like a tester or a comparison shopper, or something like that?

Mr. CAHOUET. Mr. Chairman, one way or the other, yes.

Mr. DINGELL. Now I gather from what you are telling me that the kind of survey data that we heard yesterday about retired and elderly receiving a disproportionate number of advances from their banks regarding investment strategies and mutual funds are not going to be something that is going to be tolerated by you as this process goes forward?

Mr. CAHOUET. You are correct, Mr. Chairman.

Mr. DINGELL. Mr. Cahouet, yesterday we saw that many banks that currently engage in the sale of mutual funds tout the benefits of mutual funds in big, bold print. They tend to put the disclaimers regarding FDIC insurance in footprints, or in tiny print. I assume that that will not be a practice in which you will engage?

Mr. CAHOUET. That is correct, and that is one of the reasons that we have decided to be so prominent in putting signs on our doors, both going into the branches and coming out of the branches.

Mr. DINGELL. Now what about where the funds are sold, I assume you will have similar disclaimers where the funds are sold?

Mr. MCGUINN. Yes, sir, that is what I mentioned before. This sign that sits here sits both where the tellers are and over on all the desks where the customer service representatives are. In addition, we have all of these oral and written disclosures I talked about before.

Mr. DINGELL. I assume they will be of the size and character that will be readable and understandable?

Mr. MCGUINN. Yes, sir. We believe they are. But, as Mr. Cahouet said before, if for any reason we find out when we are testing that our customers don't understand, we will seek to clarify them. But I think it is important to recognize, too, we even have a form that is described as a customer disclosure form, and it is very separate and all of these disclosures are spelled out where the customer signs.

Mr. DINGELL. Would you submit that for the record to us, please?

Mr. MCGUINN. Yes, sir, I would be happy to.

Mr. DINGELL. Now, in addition, one of the curious practices we observe is that the sellers, banks and mutual funds, disclaim FDIC insurance but they also tout SIPC insurance. That seems to be kind of a questionable practice to me. What are your feelings about it?

Mr. MCGUINN. We have worried, sir, about the difference between FDIC insurance and the SIPC membership description, and where we are required to note that we are a member of SIPC, we do that, but we are just now in the process of eliminating the SIPC reference on all of our various documents just in order to avoid that confusion as you have pointed out.

Mr. DINGELL. I assume that you will make plain what, in fact, SIPC does for them in terms of the protections that it affords?

Mr. MCGUINN. Yes, sir. In any case, where we do use it, which we intend to be limited, we will explain the difference between that and FDIC insurance.

Mr. DINGELL. We heard another complaint related to the development of prospectuses where by lay-readers could not understand even the most basic aspects of the fund. I assume that that is a practice that you would eschew and, quite frankly, would probably be critical of; am I correct?

Mr. MCGUINN. Yes, sir. We think by having these trained and licensed PIC's and, again, following up to make sure that the suitability analyses are being used and understood, and the various disclosures are as well, that in fact we will be able to accomplish having our customers informed and knowledgeable.

Mr. DINGELL. I gather you are telling me it should be done in language that would not require the understanding of a Philadelphia lawyer?

Mr. MCGUINN. Yes, sir. We believe that all our customers will be able to understand it.

Mr. DINGELL. Mr. Cahouet, what kinds of things can be done here to ensure that prospectuses are basically user-friendly to the average investor who is not always very sophisticated and doesn't have a great appreciation of language or of financial or banking or investment banking terms.

Mr. CAHOUET. That is always a problem because you have to conform with the SEC requirements.

But maybe, Howard, you or Joe?

Mr. DIMARTINO. Mr. Chairman, the prospectus disclosure requirements, as you know, are the SEC requirements. What we try to do in our material is accompany that with literature which is approved by the NASD in the form of question and answer brochures and in the form of a guide, in effect, to the fund, to the types of investments in the fund, and the privileges that are available in the prospectus that accompanies that.

Mr. DINGELL. Would you submit us samples on that for the record, please?

Mr. DIMARTINO. I would be happy to, Mr. Chairman. [See response on p. 839. The brochures referred to may be found in subcommittee files.]

Mr. DINGELL. Now, Mr. Cahouet, you have made a remarkable presentation to this committee with regard to the intention of Mellon and Dreyfus when the merger is consummated, and you have indicated that these would remain in place for 2 years. Is there a reason why you have put that 2 year limit on it?

Mr. CAHOUET. Not particularly, Mr. Chairman.

Mr. DINGELL. As a reader of fine print, when I see something like "2 years" I wonder does this mean that this is all good for 2 years, at the end of that my warranty expires?

Mr. CAHOUET. No. I think that—no, that is not the case at all.

Mr. DINGELL. I shouldn't set my calendar then for 2 years hence and figure that we are going to have another hearing?

Mr. CAHOUET. I understand the question but, for example, in regard to Dreyfus, with the combination with Dreyfus, Mellon will have roughly $220 billion under management. We currently have about $120 billion, $130 billion right now. Of that, about $190 billion of it will be in subsidiaries that are regulated by the SEC, and we certainly would make the commitment to you that as long as the SEC is regulating mutual funds, the mutual fund industry, we would certainly commit that Dreyfus will be under SEC regulation.

Mr. DINGELL. Now let me ask this question, you have made all of these commitments, and I have confess myself very much impressed by that, and I mean that honestly, gentlemen, do you regard these commitments as being hurtful in the conduct of your banking business, Mr. Cahouet, or you, Mr. Stein, in connection with the mutual fund business?

Mr. CAHOUET. The answer is no. Currently, at Mellon, we have the bulk of our money that we manage is managed in subsidiaries that are under regulation by the SEC. But more importantly, what

is most important to us is that we conduct our business affairs in a very proper way because that is good business. Pure and simple, it is good business, it is good for the customer but it is also good for our shareholders.

Mr. DINGELL. As a matter of fact, what you are saying really is what I have had occasion to say many times and that is, people think that the securities industry runs on money, it doesn't, it runs on confidence, and if the people have confidence it makes lots of money for everybody.

I gather that your view is that your commitments on these matters are matters with which a responsible bank or a responsible mutual fund, or responsible broker-dealer could comfortably live; is that right?

Mr. CAHOUET. Yes. I mean, that is the way we run the whole bank, the whole organization.

Mr. DINGELL. If the Comptroller were to impose these standards on you, I gather that you would not then object, as a condition for the application?

Mr. CAHOUET. That's correct.

Mr. DINGELL. Now would it be fair to say that nobody else ought to have a complaint if the Comptroller imposed similar standards on them?

Mr. CAHOUET. Well, Mr. Chairman, I don't want to speak on behalf of other people. I can feel quite comfortable speaking on behalf of our organization.

Mr. DINGELL. Well, you are a responsible organization. I would assume that if one responsible organization can accept these standards, every other responsible organization can accept them. Now, is that an unfair inference on my part?

Mr. CAHOUET. Mr. Chairman, I would say that that is fairly consistent deductive reasoning.

Mr. DINGELL. I guess, having said that, that unethical and rascally practitioners might have some difficulty with serving the public interest if they didn't have these kinds of standards to confront, either internally or because of the rules and regulations of the Comptroller of the Currency or perhaps, if this committee succeeds, the SEC. Is that a fair observation?

Mr. CAHOUET. We certainly hear you, Mr. Chairman.

Mr. DINGELL. Very well.

The Chair is going to recognize the gentlewoman from Pennsylvania.

Ms. MARGOLIES-MEZVINSKY. Thank you, Mr. Chairman.

I would like to enter an opening statement into the record, if there is no objection.

Mr. DINGELL. Without objection, so ordered.

[The prepared statement of Ms. Margolies-Mezvinsky follows:]

OPENING STATEMENT OF HON. MARJORIE MARGOLIES-MEZVINSKY

Thank you, Mr. Chairman for holding these important hearings. I am eager to hear the testimony today from Comptroller of the Currency Ludwig as well as from the CEO's of Mellon Bank Corporation and the Dreyfus Corporation. Yesterday's important and expert testimony from the three distinguished panels brought to light key concerns relating to this proposed merger. I look forward to further exploring these issues with our witnesses today.

Specifically, I want to learn in greater detail how the architects of this proposed merger intend to protect the consumer and safeguard consumer interests.

I am pleased to insert into the record a recent article in the Wall Street Journal which highlights an innovative program that Mellon Bank launched to expend mortgage lending in the inner city. Mellon has launched programs in the past to improve conditions for their customers.

Now Mellon Bank Corporation faces another great challenge: to continue protecting and satisfying the consumer in the face of changes to the banking environment a merger like this one would create.

Reaching Out

Under Strong Pressure, Banks Expand Loans For Inner-City Homes

Mellon Seeks Out Borrowers In Philadelphia Program; Groups Teach Budgeting

It's 'Everything I Wanted'

By KENNETH H. BACON
Staff Reporter of THE WALL STREET JOURNAL

PHILADELPHIA – When Rubbie Clark set out to buy her first home, she had three strikes against her – a blemished credit record, low savings and the prospect that she could find an affordable house only in an inner-city neighborhood where banks have long been reluctant to lend.

But after completing a financial-counseling program with a community group, Ms. Clark repaired her credit record and in 1991 qualified for a mortgage from Mellon PSFS, the Philadelphia unit of Mellon Bank Corp. The 43-year-old office worker borrowed 95% of the cost of her $36,000 row house, where she lives with her foster-daughter and nephew.

Her loan is part of a quiet revolution at American banks, which are rewriting their lending rules to make it easier for minorities and lower-income people to borrow. The banks are being shamed into action by community groups and threatened by federal regulators policing fair-lending laws.

High-Priority Issue

The Clinton administration has placed a high priority on the issue. Just last week, the Treasury Department's Office of Thrift Supervision rejected applications from four thrifts in New Jersey and Ohio to trade in their federal charters for state licenses. The agency ruled that they hadn't met the provisions of the 1977 Community Reinvestment Act, which requires banks and savings and loans to lend in all areas in which they take deposits.

Increasingly, banks such as Mellon are working with the Association of Community Organizations for Reform Now, churches and other community groups to reach out to new borrowers. It was after attending a church meeting on how to buy a house that Ms. Clark decided to apply for a loan. Despite her dream of home ownership, she had never sought a mortgage from bankers because "there was nothing that made me think they would have given me one."

Now, her house in a North Philadelphia neighborhood called Nicetown "has everything I wanted – hardwood floors and an enclosed front porch," she says. And it has one advantage she didn't expect: Her monthly mortgage payment, including taxes and insurance, totals $319, compared with the $425 a month she had paid to rent a one-bedroom suburban apartment.

Financial System Changing

Slowly, it seems, the U.S. financial system is changing. Mellon Bank seeks out applicants from inner-city neighborhoods and has more than doubled its loans to low- and moderate-income people. A decade ago, Acorn says, it wrapped a Mellon office in red tape in protest of alleged red lining; now Acorn and the bank work side by side. Fleet Financial Group Inc., after years of pressure, has just announced a program to boost lending to such home buyers and to minority-owned businesses. NationsBank Corp. and Chemical Banking Corp. already have launched similar programs.

The banks are learning that they can make a profit on such lending and develop new customers as well through counseling and other programs. "We believe it's the right way to get at this issue of neighborhood investment," says Paul Beideman, president of Mellon PSFS. Mellon has similar programs throughout its business area in Pennsylvania, Maryland, Delaware and Boston, Mass., but the Philadelphia program is the most aggressive.

The outreach efforts follow three years of damning studies by the Federal Reserve Board that were based on racial-lending data collected under the Home Mortgage Disclosure Act. The figures showed that blacks were more than twice as likely to be turned down for mortgages as whites with similar incomes.

Bankers initially criticized the reports as misleading because they focused on the race, rather than the credit risk – as measured by other loans outstanding, income stability and savings – of mortgage applicants. But the reports gave new evidence of discriminatory lending patterns to community groups and galvanized regulators and the Justice Department to act.

In response, lenders, while denying conscious discrimination, are changing their practices. "The era of finger-pointing has long passed," says Stephen Ashley, president of the Mortgage Bankers Association. "We must address discrimination head-on. We must increase our outreach and marketing efforts to communities."

Mellon's Program

Ms. Clark owes her mortgage to a cooperative effort by Philadelphia banks and community groups to help minorities and low- and moderate-income people buy houses. Mellon PSFS, which made Ms. Clark's loan, extended 573 loans to low- and moderate-income borrowers under its Neighborhood Banking Program last year, up from 223 such mortgages in 1990. The Mellon unit, which operates only in the Philadelphia area, says 55% of these loans went to minority borrowers last year

Overall progress is slow, however. Despite efforts to expand minority lending, the Fed numbers show that in 1992, the

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Reaching Out: Under Pressure, Banks Lend More in Inner Cities

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last year for which federal figures are available, blacks were rejected twice as often as whites for loans. But the rejection rates don't reflect an increase in credit because such rates measure only denials as share of total applicants; the figures don't focus on lending volume. Moreover, the banks trying hardest to serve the inner city are, by reaching out to less credit-worthy applicants, more likely to have high rejection rates. So, despite such stubbornly high rates, more credit is flowing to people and areas that banks had avoided.

Loans to lower-income people have risen. In 1992, conventional home-purchase loans to borrowers with incomes below the local median rose 27.1%, more than double the growth in loans to borrowers whose incomes are equal to or greater than the median, according to the Federal Reserve Board's latest data. And in 1992, the number of loans to blacks rose faster than those to whites.

Part of what is changing is the perception that poorer borrowers necessarily carry greater risks of default. That just isn't true, bankers increasingly say. A low-income homeowner will go to unusual lengths to keep from having a house repossessed. "Customers really don't want to lose their property," Mr. Biedeman says. And while poorer people are more likely to miss payments than wealthier people, the "higher delinquencies don't necessarily mean higher losses," he says, because Mellon works closely with delinquent borrowers and credit counselors to help get payments back on track.

Another myth is that poor people can't afford mortgages. Indeed, many, as Ms. Clark once did, are paying rents that are higher. In parts of Philadelphia, a Mellon official says, "you can buy a house for $20,000 easily and pay $180 a month."

How Consortium Works

The consortium formed by Mellon and seven other Philadelphia lenders, called the Delaware Valley Mortgage Plan, works with community groups to help people with incomes of $36,000 or less purchase houses that cost $57,000 or less (in any neighborhood with homes at that price level). Frequently, the borrowers require extensive credit counseling from community groups before they qualify for loans. The counselors help them work out payment plans for old debts, design savings plans to assemble down payments and teach basic budgeting skills.

The loan terms are adjusted to fit low-income borrowers, about 80% of whom are single mothers. A key to the program's success is flexible underwriting standards that allow welfare, Social Security or food-stamp benefits to count as income and allow borrowers without bank accounts or credit cards to prove their credit-worthiness by showing that they have reliably paid their rent and utility bills.

Since the government began to highlight racial disparities in rejection rates, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp., the two government-chartered, stockholder-owned agencies that purchase mortgages from lenders, have launched new programs to help finance home buying in inner cities and poor rural areas. A 1992 law requires these companies to devote more of their resources to low- and moderate-income programs.

In its Neighborhood Banking Program, Mellon waives a demand that applicants work for two years in the same job or industry. All that is required is a steady income. Mellon also lets loan applicants use cash for down payments, an arrangement that helps low-income applicants who, in many cases, don't have bank accounts. And applicants also get a break on interest rates. Ms. Clark's 7.126% rate was 1.5 percentage points below the market rate when she got her mortgage — with a down payment of only 5%.

"Mortgages are the spine of the neighborhood" because homeowners encourage investment and development, says Bruce Dorpalen, Acorn's director of banking programs in Philadelphia. "If you can maintain property values, then people can borrow on their houses to get their roof fixed or to send their kids to college," he says.

Benefits of Counseling

Ms. Clark got her loan from Mellon after going through a credit-counseling program at Acorn. Her income as a service associate at Penn Mutual Insurance Co. was under $30,000 when she bought the house. But without counseling, some delinquent student-loan payments and other credit problems probably would have prevented her from getting a loan.

Since many low-income borrowers need help getting their finances in line, Mellon recently hired Nelson Acevedo, a former community worker, to help borrowers who are having problems meeting their payments. He meets with people who miss a payment, and, if necessary, he helps them work out alternative payment plans to avoid foreclosure. Sometimes he arranges assistance with energy bills or other temporary help from state and local agencies to pull people through periods of unusual financial strain.

The counselors and community groups seem to help bankers bridge the cultural gap that has long made the financial system inaccessible to poor or minority areas. "Bankers have very little in common with people in poor communities," Rep. Joseph Kennedy says. But, the Massachusetts Democrat says, banks in Boston and elsewhere are beginning to realize that they can build strong customer bases in communities once spurned — despite "a tremendous amount of suspicion on both sides of the street."

Even though expanding into once-shunned neighborhoods, Mellon still performs badly when measured by denial rates. Even in its Neighborhood Banking Program, it rejected 19% of the applications from black applicants last year, compared with 6% of white applications and 8% from Hispanics. "Because of our outreach, we're going to see more applications and we're going to lend more, but we're also going to turn down more," Mr. Beideman explains. All rejected applications receive a second review.

But while the disparity between rejections rates remains high, the number of loans Mellon PSFS makes to minorities has risen sharply. In 1990, Mellon made 51 loans to blacks and 39 loans to Hispanics through its Neighborhood Banking Program; last year, it made 165 loans to blacks and 128 to Hispanics. In the Philadelphia area, in fact, Mellon is making more than twice as many loans through its Neighborhood Banking Program as it does through its conventional mortgage program.

When Cynthia Henderson went to Mellon to discuss a loan, the lending officer quickly decided that she wouldn't qualify

for a normal loan because she had held her current job only six months. But the Mellon lending officer recommended that she go to Acorn for help.

Learning the Ropes

There, Allison Hughes learned that Ms. Henderson had just returned to work after a divorce, reclaiming a job at a General Electric Co. plant that she had held for several years before her marriage. Ms. Hughes was able to sort out her employment record and help Ms. Henderson plan to assemble the 5% down payment on a $44,000, two-bedroom house. She ultimately got a mortgage from Mellon and lives in an attractive row house with her three-year-old daughter.

"I love Mellon," she says, noting that she also has a car loan from the bank.

Often, financial counseling can get applicants past the rejection threshold. "It's our belief that discrimination, where it occurs, often affects applicants with some blemishes," Comptroller of the Currency Eugene Ludwig says. "In many cases, such assistance – requesting explanation of derogatory credit information, suggesting ways to improve an applicant's reported income or reduce the applicant's current debt, or offering an applicant loan options that might improve his or her ability to meet underwriting standards – can mean the difference between denial and acceptance."

More people are dropping by Acorn's second-floor walk-up office in a battered building next to a former opera house now used as a church. Richard Saffold, a relatively new counselor, is helping a 37-year-old mother of two who is interested in a loan.

"How many single parents do you deal with?" she asks.

"A lot. Maybe 70% to 80%," he says.

Relieved, she begins to answer questions about her finances and credit record. She concedes that she has more than $1,000 in unpaid bills, some of them delinquent for several years. Mr. Saffold tells her that she has to settle the bills and get them removed from her credit report before she can get a mortgage.

"For anyone who has negative comments on their credit report, the bank does require that you come to budget class," he adds. He signs her up for a series of three classes to teach her how to set up a monthly budget and manage credit.

–Steven Lipin in New York contributed to this article.

Mr. DINGELL. The gentlelady can please be recognized.

Ms. MARGOLIES-MEZVINSKY. Welcome gentlemen from Mellon and from Dreyfus.

Can you explain or outline the ways that you intend to preserve customer confidentiality?

Mr. CAHOUET. Yes. I hope I can to your satisfaction. We value very sincerely the confidentiality of our customers, and we would continue to do that as we have in the past.

Ms. MARGOLIES-MEZVINSKY. Could you be a little bit more specific?

Mr. CAHOUET. Well, we don't make the confidential information, financial information of our customers available to third parties without their consent.

Mr. STEIN. I just might add to that that in our case we always keep the information secret and we cannot have permission even to use the list, because it is owned by the funds, without the specific approval of the directors of the funds.

Ms. MARGOLIES-MEZVINSKY. Why do you think that people are so confused when they buy mutual funds through a bank?

Mr. CAHOUET. I don't know for certain. I think that inherently there is some confusion out there in the marketplace for a large part of the population, whether they buy funds from banks or mutual funds or from brokerage companies. Our interest in our organization is to do whatever we can in order to alleviate that kind of confusion and that is what we want to do because we think that we are doing a better job for our customer in the process.

I can't really comment as to why people in general, other than a lot of people are either making investments for the first time, are not particularly sophisticated in themselves as it relates to financial instruments, and haven't taken the time to understand.

Ms. MARGOLIES-MEZVINSKY. Mr. Stein?

Mr. STEIN. I think a part of the confusion, I guess, is the culture because they have been exposed for what, 60 years, to insured products at a bank, and that is something that they remember. I think it is up to us for the people who are interested in uninsured products or noninsured products to be educators over the same period of time to the fact that it does exist, what exists, and what the risks are, and that they can lose money. I think those efforts have to be made very strongly. Hopefully, they will not be as confused.

Ms. MARGOLIES-MEZVINSKY. Mr. Cahouet, I noticed that you promised to preserve the Dreyfus name and not to rename them as Mellon funds. I also understand that your existing funds, the Laurel funds, do not use the bank's name. Could you explain why?

Mr. CAHOUET. Well, the answer for the Dreyfus question is a very simple answer, and I will just say that the Dreyfus name is known the world around and it is a highly respected name, and it has tremendous value. I think that that really disposes of that issue.

As regards why we chose the Laurel name rather than using the Mellon name, quite frankly, was to avoid the confusion.

Ms. MARGOLIES-MEZVINSKY. Do you agree with many consumer groups that bank-sponsored funds that use banks' names pose a special risk to investors and depositors?

Mr. CAHOUET. I would rather only kind of comment as it relates to our organization. It is difficult for me to project myself into the other bank situations.

Ms. MARGOLIES-MEZVINSKY. Mr. Stein?

Mr. STEIN. I think having the names on the funds would only add to the confusion, and I think it is something that should be banned from that portion of the industry.

Ms. MARGOLIES-MEZVINSKY. Across the board?

Mr. STEIN. Across the board, yes.

Ms. MARGOLIES-MEZVINSKY. Can I come back to the confidentiality question, if you don't mind. I want to be sure that you are saying that customer lists, particularly those at Mellon, would not be made available to Dreyfus in an attempt to sell securities; is that what you are saying?

Mr. CAHOUET. I apologize, I didn't hear the question.

Ms. MARGOLIES-MEZVINSKY. The question is, customer lists, particularly those at Mellon, are not going to be made available to Dreyfus in an attempt to sell securities?

Mr. CAHOUET. No. I don't want to quite answer it that way, if I can. Clearly, Mellon, as well as Dreyfus, has products that are of interest or potential interest to these customers, and we don't know at this point as we sit here what is the best way to make those products available to our respective customers, but we do feel it is important for us, where we feel we are in a position to provide value-added products to our customers, to consider what is the most effective way of doing that. How we are going to do that, we don't know at this point.

Ms. MARGOLIES-MEZVINSKY. I guess I would like to follow up on a question that the Chair asked yesterday, and that is, if you were are an older woman who has just lost her husband and is a part of your bank and falls into this category, how do we protect someone like that?

Mr. CAHOUET. Well, Congresswoman, what we would be doing, as Mr. McGuinn explained in his comments, we go to great lengths to do a suitability analysis with that customer with the customer participating in that suitability analysis as to the appropriateness of any decision that she wanted to make, we used an example of a widow, at any point in time. That would be of considerable concern to us, particularly if she was just recently widowed, or something.

Ms. MARGOLIES-MEZVINSKY. I would like to know what kinds of implications might having access to such lists create for consumer protection?

Mr. CAHOUET. As I sit here today with you, I don't think that the implications would be all that serious because, realistically, if that person was inheriting money or whatever, she might be trying to make a decision and it would be important for her to have available to her people that she could talk to that could help her make that decision. So I think that probably, in most cases, it would be a positive fora rather than a negative fora.

Mr. STEIN. There is one observation about the widow, with the 125 years experience that the Mellon Bank has had with trusts, estates, it is mostly with older people who do have the funds, and I think in that area they have a very, very good record of how to handle those specific requests without getting into difficulties.

Ms. MARGOLIES-MEZVINSKY. Yesterday we heard that there are a number of banks currently selling mutual funds. Some of these banks were described as being aggressive, or attempting to develop state-of-the-art disclaimers and materials to weed out confusion but, on the other hand, others were described as bottom-feeders, those are people who had not come up to the Comptroller's guidelines. These are banks that put disclaimers in fine print or have a tendency to be confusing.

What actions do you think the Comptroller and other bank regulators ought to take against these so-called "bottom-feeders"?

Mr. STEIN. I think the first action that should be taken is the passage of the Dingell-Markey Bill. I think that would be a great step towards eliminating the problems.

Next, I think that the meeting here and the hearing today will have a very significant influence on the action of the OCC because the problem in the industry is a very short one. It is just occurring, and the knowledge of the problem is occurring in about the last 6 months, that everyone is becoming aware of this confusion. They were here, I think they heard a good deal about the problem, and I think they are beginning to make efforts to bring in the appropriate legislation and the appropriate guidelines or rules or laws, in effect, that deal with the problem. I think the meeting made everybody aware of what has to be done.

I feel confident that the institutions and the regulatory bodies will move in the direction of finding the appropriate regulation to eliminate these confusions.

Ms. MARGOLIES-MEZVINSKY. Mr. Cahouet?

Mr. CAHOUET. Well, I think that misleading statements advertising whatever is terribly wrong and shouldn't be tolerated in any sense, and where that appears a corrective action should be taken. It is very dangerous and shouldn't happen, and the people trying to take advantage by misrepresenting themselves, false advertising, it just has to get routed out. It is bad for the industry, it is bad for the people that are involved. We just shouldn't have it.

Ms. MARGOLIES-MEZVINSKY. Thank you, gentlemen.

Thank you, Mr. Chair.

Mr. DINGELL. The Chair thanks the gentlewoman.

The gentleman from Colorado, Mr. Schaefer.

Mr. SCHAEFER. Thank you, Mr. Chairman.

Gentlemen, I just have a couple other questions here. Due to the fact of the Keating problem, Lincoln, et cetera, I am still unclear about the role that bank tellers are supposed to play when a customer asks them about the possibility of switching from a deposit that is earning lower interest to something beyond that. What is the procedure, what do you see as the procedure? I mean, are they going to go to a customer representative, or are they going to have a brochure, or what?

Mr. CAHOUET. Mr. Congressman, I would like to ask Mr. McGuinn if he would respond to that because that is a very important question.

Mr. SCHAEFER. Certainly.

Mr. MCGUINN. Yes, sir. Remember now that the customer is standing at the teller window, and there is this sign that I showed you before which makes these various disclosures. At that point in

time, if the customer inquired as you indicated, our tellers actually have a laminated card which they are required to read from, too, which also orally supplements that disclosure on the sign and goes into the fact that investment products are not insured by the FDIC and are not guaranteed, and so forth.

After having done that, the teller would then refer that customer over to a customer service representative who, if the customer wanted to make an appointment with one of our PIC's to get investment advice, that appointment would be made. Then the customer would be dealing with that licensed and trained PIC.

Mr. SCHAEFER. The chairman sent a letter to Mr. Stein and Mr. Cahouet on January 28th of 1994 to which you responded, I am understanding from staff in the response, and this was dealing with compensation for tellers, that it indicated that the referrals by tellers and branch platform staff to InvestNet brokers can result in increased compensation to tellers and branch platform staff although the increased compensation is linked only indirectly to the referrals. This is basically what you said.

Now, in other words, the tellers are going to get compensation?

Mr. CAHOUET. Well, sir, they will only indirectly, as that statement indicates, and what that means is the tellers are part of a whole branch compensation system which is based on a variety of factors to build a team effort. But a couple of points are very important, I think.

One, none of those teller referrals, as I just described, over to the customer service representative depend on whether or not a sale is ever made.

Second, in terms of just having made the referral itself, that is one of just many factors that would go into the team award for that particular branch and, indeed, among the many factors considered, actually a deposit sale would be given more credit than even a noninsured product sale.

Mr. SCHAEFER. One final one. Some of the responses to, again, the chairman's questions, referred to self-directed customers. Are self-directed customers ones who are approached telemarketing-wise, or through ads, or whatever else it is? How do the tellers and customer service representatives distinguish them from the nonself-directed? What is a self-directed?

Mr. CAHOUET. Well, sir, a self-direct customer I would interpret to mean somebody who is not seeking investment advise but rather has read about the Dreyfus fund or has read about a particular mutual fund and wants to come in and buy that mutual fund. In that case, that customer would be referred, again, to our InvestNet broker-dealer subsidiary where the customer could place the order. No investment advice is given, it is just a regular broker-dealer member of NASD.

Mr. SCHAEFER. In other words, they are coming in knowing what they want?

Mr. CAHOUET. Yes, sir.

Mr. SCHAEFER. Thank you, Mr. Chairman. I am finished.

Mr. DINGELL. The Chair thanks the gentleman.

Gentlemen, Mr. McGuinn, Mr. Cahouet, Mr. Stein, Mr. DiMartino, the subcommittee thanks you. We have kept you here a long time. We appreciate your courtesy to us. We know you have

answered a great number of questions, responded to the concerns of the committee, and I want to express to you my personal thanks for the time you have given us and for your presence today and for your assistance to us as we have considered this matter. Gentlemen, thank you very much.

The subcommittee stands adjourned.

[Whereupon, at 4:17 p.m., the subcommittee was adjourned.]

[The following subcommittee memorandum, OCC final order, and correspondence were submitted:]

ROOM 2323
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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 1, 1994

M E M O R A N D U M

TO: Members, Subcommittee on Oversight and Investigations

FROM: The Honorable John D. Dingell, Chairman

SUBJECT: Subcommittee Hearing on Proposed Acquisition of Dreyfus Corporation by Mellon Bank Corporation

INTRODUCTION

The Subcommittee on Oversight and Investigations will hold hearings on Wednesday, March 2, 1994, and Thursday, March 3, 1994. Both days of hearings will commence at 10:00 a.m. in Room 2123 of Rayburn House Office Building. The hearings will focus on the significant legal, public policy, and consumer protection issues raised by the proposed Mellon-Dreyfus transaction, as well as on the adequacy of existing safeguards in connection with mutual funds and other securities products advised on or sold by banks or their affiliates.

On December 6, 1993, Mellon Bank Corporation (Mellon), a major bank holding company, and Dreyfus Corporation (Dreyfus), one of the largest mutual fund investment advisers and managers in the United States, announced that they had entered into a merger agreement. See Mellon Bank & Dreyfus, "Mellon Bank Corporation and the Dreyfus Corporation to Merge in Stock Transaction Valued at $1.85 Billion," Dec. 6, 1993.

Dreyfus serves primarily as an investment adviser and manager of mutual funds and, through a wholly owned subsidiary, Dreyfus Service Corporation, as distributor of the shares of the Dreyfus Group of Mutual Funds. In addition, Dreyfus provides investment advisory and administrative services, directly and through a wholly owned subsidiary, Dreyfus Management, Inc., to various pension plans, institutions and individuals. Accordingly, Dreyfus Service Corporation is registered with the Securities and Exchange Commission (SEC), the National

Association of Securities Dealers (NASD), and all fifty states as a broker-dealer, and Dreyfus Management Inc. is registered with the SEC and several states as an investment adviser. Based upon assets under management, Dreyfus, the sixth largest mutual fund organization in the country, manages 130 mutual fund portfolios with approximately 2 million shareholder accounts and $72.2 billion in assets.

Ranked by asset size, Mellon is the 21st largest bank holding company in the United States. Mellon Bank, its lead banking subsidiary, is currently 22nd among banks in mutual fund assets under management. If the merger is completed as proposed, Dreyfus will become a direct operating subsidiary of Mellon Bank. Mellon states that a principal reason for adoption of this structure is to enable Mellon Bank "to use, for regulatory and accounting purposes, both the strong capital base that Dreyfus has accumulated and Dreyfus' significant earnings." Dreyfus brings to Mellon Bank approximately $800 million in equity capital without any debt liabilities. Mellon Bank already advises one family of funds, the Laurel funds; in addition, last year, its parent company acquired the investment adviser to The Boston Company funds. Once the pending merger is completed, Mellon Bank and its affiliates, including Dreyfus, will be the largest bank mutual fund investment adviser, with $76.8 billion in mutual fund assets under management. This represents four percent of all mutual fund assets.

THE TRANSACTION

On December 30, 1993, Mellon Bank and Mellon Bank (DE) National Association filed a Notice with the Comptroller of the Currency (OCC) pursuant to 12 CFR section 5.34 of their intention to establish operating subsidiaries in connection with the acquisition of Dreyfus and its subsidiaries. Necessary applications have also been filed by Mellon with the Board of Governors of the Federal Reserve System (Federal Reserve Board) and the Office of Thrift Supervision. An application will be filed with the New York State Banking Department. Mellon also has made Hart-Scott-Rodino filings with the Department of Justice and the Federal Trade Commission.

The details of the proposed merger are set forth in the Agreement and Plan of Merger dated December 5, 1993. The key terms include:

1. The transaction is structured as an exchange offer, with Dreyfus shareholders to receive .88 shares of Mellon common stock for each share of outstanding Dreyfus common stock.

2. Dreyfus will retain its headquarters in New York City and will be operated as an independent entity registered with and regulated by the SEC for at least two years.

3. Dreyfus' distribution function will be sold to an independent, third party distributer.

4. Mellon will retain current Dreyfus management and fund managers and the Dreyfus name will continue to be used for funds managed and advised by Dreyfus.

5. Mellon and Dreyfus expect the transaction to close in mid-1994, assuming that banking regulators approve the transaction and the shareholders of both corporations ratify the proposed merger.

The acquisition or establishment of an "operating subsidiary" by a national bank, such as Mellon Bank, is subject to 12 CFR section 5.34, the OCC's so-called "op-sub" rule. The rule currently provides that:

1. All federal banking laws and regulations which apply to the operations of the national bank also apply to the subsidiary's operations;

2. The OCC may impose legal and supervisory conditions on the national bank with respect to the subsidiary's operations; and

3. The operating subsidiary is subject to examination and supervision by the OCC in the same manner and to the same extent as the parent bank.

12 CFR section 5.34 also establishes procedures to be followed when a national bank proposes to acquire an operating subsidiary:

1. The OCC reviews the bank's proposal to determine if the proposed activities exceed those legally permissible for a national bank's operating subsidiary and to "ensure that the proposal is consistent with prudent banking practice."

2. In contrast with the Federal Reserve Board's procedures under the Bank Holding Company Act, the OCC does not publish notice of proposals by national banks to establish or acquire operating subsidiaries in the Federal Register.

3. Thus, third parties generally are not invited to comment on proposals by national banks to engage in securities activities through operating subsidiaries and may not learn the details of a specific proposal until after it has been acted upon by the OCC.

4. Generally, a bank is free to commence operations within 30 days of filing its notice unless otherwise advised by the OCC.

It has been reported that the OCC is considering revisions to 12 CFR section 5.34 which would expand the range of securities activities which national banks could engage in through operating subsidiaries. See "OCC to Loosen Shackles of Bank Securities Units," American Banker's Washington Watch (Dec. 6, 1993).

Mellon's application with the OCC included a Policy Statement on Mutual Funds that provides "guiding principles" for sales of mutual funds by Mellon, its bank subsidiaries and its other subsidiaries; relationships between these entities and mutual funds for which they provide advisory services; and relationships between Mellon bank subsidiaries and Dreyfus, as a subsidiary of Mellon Bank, the principal Mellon bank. The Policy Statement contains a number of "voluntary commitments" aimed at: (1) providing customers with disclosures of the benefits and risks of investing in mutual fund shares, and particularly ensuring that customers are clearly informed that such shares are not insured by the Federal Deposit Insurance Corporation (FDIC) and are not bank obligations; (2) assessing the suitability of mutual funds that a Mellon company recommends; (3) ensuring the safety and soundness of both the Mellon banks and Mellon-advised funds; (4) preventing conflicts of interest; (5) maintaining separation between Mellon companies and Mellon-advised funds; and (6) maintaining separation between Mellon banks and Dreyfus. These undertakings are based on H.R. 3447, the Securities Regulatory Equality Act, a functional regulation bill which was introduced on November 4, 1993 by Representatives Dingell, Moorhead, Markey and Fields. (On October 19, 1993, Representatives Schumer and Gonzalez introduced H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act, to regulate the retail sale of nondeposit investment

products by insured depository institutions to prevent customer confusion about the uninsured nature of the products.)

THE ISSUES

The proposed Mellon-Dreyfus merger presents the most striking example thus far of bank involvement in the mutual fund industry. It is estimated that about 40 million Americans (representing 27 percent of households) own shares in at least one mutual fund. Currently 113 banks or bank subsidiaries advise 943 mutual funds and bank mutual funds have $204 billion in assets, an increase of 29% since December 31, 1992. Banks also are increasingly active in selling mutual fund shares to the public. In the first half of 1992, banks reportedly accounted for one-third of all new sales of money market funds and 14 percent of all new sales of long-term funds. More generally, nearly one-quarter of America's banks do some sort of brokerage business.

For decades, the so-called Glass-Steagall Act constituted a bar against banks engaging in most securities activities. Over the last two decades, however, the federal bank regulators have expansively interpreted the Glass-Steagall Act to permit banks to engage in a wide range of brokerage and other securities activities, including sales of mutual funds and other securities to the investing public. In the prevailing interest rate environment, bank customers with maturing certificates of deposit reportedly have been investing their funds in record numbers in mutual funds. A survey conducted by the SEC in November 1993 showed that 66 percent of bank fund shareholders believe that money market mutual funds sold through banks are federally insured, while 28 percent of respondents believe that all mutual funds sold through banks are "federally insured like savings accounts and Cds." These developments have raised a number of concerns including the risk of customer confusion, disregard of disclosure standards and suitability considerations, the creation of conflicts of interest, and the lack of adequate safeguards. _See_ "Should You Buy Mutual Funds From Your Bank," _Consumer Reports_ (March 1994) (attached).

The SEC currently regulates all mutual funds under the Investment Company Act, including bank advised funds. Due to statutory provisions that exclude banks from the regulatory requirements that apply to investment advisers and broker-dealers, however, the SEC has only limited ability to regulate the banks that advise and/or sell interests in such mutual funds. It has been suggested that these bank exclusions should be eliminated in light of the dramatic increase in bank securities activities over the past decade, and especially since banks are

among the largest participants in the securities business (as illustrated by the Mellon-Dreyfus merger).

Last year, the four federal banking regulators issued separate "guidelines" designed to address safety and soundness and customer confusion issues raised by bank securities and mutual fund sales. In response to sharp criticism of the conflicting "guidelines," two weeks ago, the banking agencies issued a joint Interagency Statement on Retail Sales of Nondeposit Investment Products intended to consolidate, standardize, and supersede the earlier separate guidance. The Statement is hortatory in nature and leaves a great deal of leeway to the banks as to interpretation and implementation. The document notes that: "failure of a depository institution to establish and observe appropriate policies and procedures consistent with this Statement in connection with sales activities involving nondeposit investment products will be subject to <u>criticism and appropriate corrective action</u>." (emphasis supplied) While the Statement indicates that "compliance procedures should provide for a system to monitor customer complaints and their resolution," federal banking laws do not contain private rights of action for investors and there is no banking law counterpart to the securities arbitration scheme for bank securities investors. Bank securities sales personnel are not tested for competence, nor are they subject to an examination and disciplinary program, such as the program administered by the NASD, that focuses on the potential for abuse that exists in connection with retail securities activities. On February 1, 1994, six national banking trade associations released joint "guidelines" pertaining to the sale of mutual funds and other noninsured products in banks.

CONGRESSIONAL RESPONSE

On December 20, 1993, Chairmen Dingell and Gonzales jointly wrote to Mellon and Dreyfus, the OCC, and the SEC, and on January 26, 1994 again to the OCC requesting documents and responses to the serious questions raised by the proposed transaction. The Subcommittee sent investigative letters to Mellon and Dreyfus and to the OCC on January 28, 1994, to the FDIC and the Federal Reserve Board on February 14, 1994, and to the SEC and to the OCC on February 23, 1994. Copies of these letters and the responses thereto are appended to this memorandum.

Among other things, the Gonzalez-Dingell letters criticized the lack of public notice. On February 24, 1994, in what the <u>Wall Street Journal</u> labeled "an unusual move," the OCC published in the <u>Federal Register</u> a request for public comment on two notices filed by national banks of their proposed establishment of operating subsidiaries that will engage in mutual fund

activities: the Mellon Notice discussed above, and the Notice filed by First Union National Bank of North Carolina on November 1, 1993 with respect to First Union's intent to acquire two affiliated investment advisory companies, Lieber & Company, and Evergreen Asset Management Corporation. Comments are due by March 28, 1994.

The two chairmen also raised concerns about the adequacy and enforceability of the voluntary commitments. The OCC can seek cease-and-desist orders under 12 U.S.C. section 1818(b) based on violations of "law, rule, or regulation, <u>or any condition imposed in writing by the agency in connection with the granting of an application</u>." (emphasis supplied) Thus, the Mellon-Dreyfus Policy Statement is unenforceable unless its terms are imposed by the OCC as written conditions in a letter approving the merger. If a policy guideline is not set forth as a condition imposed in writing, the OCC may initiate cease and desist proceedings, only if the violation of the guideline constitutes "an unsafe or unsound banking practice."

GLASS-STEAGALL ANALYSIS/PERMISSIBLE ACTIVITIES

The Glass-Steagall Act prohibits a bank from engaging in "the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks...or other securities." (Sections 16 and 21 of the Glass-Steagall Act, 12 U.S.C. 24(seventh) & 378). The Supreme Court has indicated that this also includes a prohibition on engaging in the "public sale" of securities. Thus, the relevant inquiry under the Glass-Steagall Act is whether, under the proposal, Mellon Bank would, through its proposed Dreyfus operating subsidiaries, be engaged in any of these prohibited activities.

The National Bank Act permits national banks to conduct "all such incidental powers as shall be necessary to carry on the business of banking". 12 U.S.C. 24(Seventh). This provision has been interpreted by the courts to permit national banks to conduct activities that are "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act." <u>M&M Leasing Corp. v. Seattle First National Bank</u>, 563 F.2d 1377 (9th Cir. 1977). The OCC's rules regarding the establishment of an operating subsidiary limit the operating subsidiary to activities that a national bank is permitted to conduct directly. (12 CFR 5.34).

The Bank Holding Company Act provides that the Federal Reserve Board may authorize bank holding companies to invest in companies that engage in activities that are "so closely related to banking as to be a proper incident thereto." (12 U.S.C.

1843(c)(8)). In considering whether an activity is "closely related to banking," the Federal Reserve Board and the courts have considered whether:

1) banks generally have, in fact, provided the service;

2) banks generally provide services that are operationally or functionally so similar to the proposed service as to equip them particularly well to provide the proposed service; or

3) banks generally provide services that are so integrally related to the proposed service as to require their provision in a specialized form. See National Courier Ass'n v. Board, 516 F.2d 1229 (D.C.Cir. 1975).

WITNESSES

Arthur Levitt, Chairman, SEC, accompanied by Barry P. Barbash, Director, Division of Investment Management, SEC, will testify on the current regulatory structure governing the securities activities of banks and the functional regulation issues that are highlighted by the proposed transaction. Currently, investors who purchase securities directly from banks are not protected by the securities regulatory scheme administered by the SEC, and federal banking law does not provide a comparable regulatory scheme focused on investor protection. The SEC will urge Congress to eliminate the existing regulatory gaps.

A panel of State and federal prosecutors and a civil attorney involved in the trial of Charles H. Keating, Jr. and Lincoln Savings and Loan in Southern California will testify. The witnesses -- William W. Hodgman, a prosecutor for the State of California, Steven E. Zipperstein and Alice Hill, prosecutors from the U.S. Attorney's Office, and Len Simon, a civil attorney from the San Diego law firm of Milberg Weiss Bershad Hynes & Lerach -- will highlight some of the consumer protection issues stemming from the Lincoln case. The witnesses will describe the methods and procedures used by the parent company of Lincoln (American Continental Corporation) to sell bonds through direct affiliation with Lincoln, and also detail some of the many consumer problems that resulted from that affiliation. Moreover, the witnesses will detail how customers were misled, both intentionally and unintentionally, into thinking that the bonds they were purchasing were federally insured and risk-free, despite written disclosures about the true nature of these investments.

A panel comprised of consumer groups will testify on the growing evidence of consumer confusion and the lack of effective safeguards in connection with mutual funds and other securities products advised on or sold by banks and their affiliates. Lena Archuleta, a member of the Board of Directors of the American Association of Retired Persons (AARP), will testify on how a vulnerable segment of the population such as retired persons can be misled into shifting from low-yield insured investments to higher-yield, riskier investments without fully understanding the risks involved. Ms. Archuleta will be accompanied by Diane Colasanto, from Princeton Survey Research Associates, who will present the results of a survey conducted jointly by AARP and the North American Securities Administrators Association (NASAA) which points to a significant level of consumer confusion. The President of NASAA, Mr. Craig Goettsch, will testify on some of the practices that various banks across the country currently employ in their lobbies to market securities and other uninsured products, and the ways in which consumers can be misled into thinking that these investments are federally insured when in fact they are not. Lastly, Mr. Chris Lewis, Director of Banking and Housing Policy at the Consumer Federation of America (CFA), will testify on the CFA's concerns regarding the direct involvement of banks in the selling of securities and the numerous consumer protection issues raised by such activities.

Frank V. Cahouet, Chairman, CEO and President, Mellon Bank Corporation, Martin G. McGuinn, Vice Chairman, Mellon Bank Corporation, Howard Stein, Chairman and CEO, The Dreyfus Corporation, and Joseph S. DiMartino, President and Chief Operating Officer, The Dreyfus Corporation, will testify on the terms and conditions of the merger, their respective rationales for the transaction, the regulatory approvals required, the Glass-Steagall analysis, and the proposed protections with respect to bank safety and soundness, customer confusion, conflicts of interest, and investor protection. The parties will testify that this transaction is responsive to the demands of their customers and the marketplace, and is a natural and lawful step in the evolution occurring within the financial services industry.

Eugene A. Ludwig, Comptroller of the Currency, will testify on the legal and policy issues raised by the proposed acquisition. Mellon represents that, should the proposed transaction be permitted, Dreyfus would engage only in mutual fund activities the OCC has previously found to be permissible for national banks and their operating subsidiaries and would discontinue all other mutual fund activities. The OCC must review Mellon's filing to determine if the proposed activities are, in fact, permissible for national banks and their operating subsidiaries. In addition, the OCC must analyze the risks and other concerns that

may arise because of the magnitude and complexity of the proposed transaction. The OCC has indicated that it would approve the transaction only if all safety and soundness, customer protection, conflict of interest, and related concerns had been fully considered and addressed. The OCC's testimony on the transaction, and that of First Union-Evergreen, will be constrained by the fact that OCC has sought public comment thereon and has not made final decisions and taken final agency actions thereon.

OTHER STATEMENTS

The FDIC advised the Subcommittee in a letter dated February 25, 1994 that:

> There are approximately 13,400 FDIC-insured depository institutions with approximately $4,600 billion in assets. (A.2.)
>
> The FDIC is not able at this time to precisely state the number of banks and affiliates engaged in securities sales or advisory activities. Our regions indicate that one-third or more of state nonmember banks may be doing so. Changes in to the bank Call Reports are being made to collect this information. (A.2.)
>
> There is no application or notice required of insured nonmember banks before they engage in securities activities directly in a bank. (A.3.)
>
> The FDIC has no aggregate data concerning the securities activities of insured institutions for which the FDIC is not primary supervisor. (A.3.)
>
> FDIC examinations of bank sales of securities focus on the bank's policies and procedures. The FDIC does not use testers to check on actual bank practices in dealing with customers. (A.1.b.)
>
> FDIC has taken no formal enforcement actions to date concerning bank securities activities. Examiners who find violations ask banks to improve disclosures and better document polices and procedures. (A.3.)

* * *

SHOULD YOU BUY MUTUAL FUNDS FROM YOUR BANK?

Our investigation of 40 banks in five states found bad investment advice and outright lies about safety.

Some 3500 banks across the U.S. now sell mutual funds. And many of those banks sell them aggressively. Through the third quarter of 1993, the money invested in bank mutual funds was growing 40 percent a year—almost twice as fast as the fund industry in general.

Banks aren't just selling mutual funds. They're also advising customers on what to buy. Banks may sell funds from an independent company such as Fidelity, Colonial, or Franklin. Or, as about 125 banks now do, they may offer their own line of mutual funds.

For this report, we put the banks' recommendations to the test. A CU reporter, representing himself as a customer with money from a maturing certificate of deposit to invest, sat down with 40 investment salespeople at banks in California, Connecticut, Illinois, New Jersey, and New York. He found that although banks endow their salespeople with authoritative titles—"investment counselor," "financial planner," and the like, customers rarely get a detailed, thoughtful, appropriate financial plan. The investment advice our reporter received was often inappropriate, sometimes wildly so.

The big picture

Our reporter gave each bank's salesperson the same basic set of facts. He had \$50,000 in CD money coming due and didn't know much about investing. He did not say that he was conducting a survey.

As a group, the salespeople stumbled badly on the basics. At a minimum, an investment adviser needs to know something about the level of risk that a client is comfortable with. But only 16 of the 40 salespeople bothered to ask any questions that would have led in that direction. On the occasions when he was asked, the reporter portrayed himself as a conservative investor who wanted to get a bit more than prevailing CD rates without taking any chances. To their credit, the salespeople who went to the trouble to probe generally made appropriate investment recommendations.

Of the 24 salespeople who didn't ask about risk, two-thirds made recommendations that included a substantial investment in aggressive-growth stock funds. Such funds are among the most risky investments; the possibility of losing money, at least over the short term, is high. Whatever their long-term potential, they are inappropriate for anyone who shuns risk.

Half of all the salespeople also failed to ask what other investments the reporter had. To make an informed recommendation, an investment counselor needs to know what else a client owns in order to get a picture of how risky that client's collective portfolio may be. That's a basic tenet of financial planning.

All told, only six of the 40 salespeople asked for what we would consider essential information and recommended investments that were appropriate, balanced, and relatively low in risk. Such investments might include short-term bond funds, municipal bond funds, asset allocation funds, money-market funds, and perhaps some conservative stock mutual funds. If our six out of 40 salespeople are representative, the odds of getting good advice at a bank that sells mutual funds are worse than 1 in 6.

It's 'guaranteed'

The sales presentations our reporter witnessed were peppered with incorrect and misleading statements. Many of the salespeople represented their investments as a sure thing, whatever those investments turned out to be.

"You'll get 10 percent guaranteed," said a salesman at Chase Manhattan Bank in New York, as he handed over prospectuses for three stock and bond mutual funds. When pressed for details of this guarantee, he retreated to: "Our funds have never lost money over a one-year period." (That's true, although the Chase funds have only been in existence for about five years, not long enough to have weathered a sustained down market.)

About one salesperson in four cited the returns of that bank's mutual funds without including the effect of commissions. One salesman, for example, touted a Government bond fund that he claimed had a one-year return of 8.7 percent. The prospectus, however, showed that after subtracting the commission, the one-year return shrank to just 4.2 percent, about the same as then-prevailing CD rates.

At Shawmut Bank in New Haven, Conn., a saleswoman was mistaken

Illustration by Michael Witte

about even the fundamentals of finance. "Buy bonds if you don't want risk," she said. "All our bond funds are very conservative." In fact, bond funds can be quite risky if interest rates change. She also claimed that bond funds were an ideal way to take advantage of rising interest rates. Just the opposite is true. The value of bonds, and bond mutual funds, falls when interest rates rise.

After a lengthy interview, a salesman at First Interstate Bank in Los Angeles recommended three mutual funds. He insisted that the bank's "completely safe" mutual funds would "lock in" a 20 percent gain with "hardly any risk." But the funds he recommended had not returned 20 percent in years past, and they would have to be considered moderate to high in risk.

At Wells Fargo Bank in Los Angeles, the salesman assured our reporter of the safety of the bank's "rock-solid, Government-guaranteed" Treasury bond fund. Indeed, the mutual fund had performed well, but it was plenty risky. The bonds in its portfolio had an average maturity of 25 years; the longer a bond fund's average maturity, the more susceptible it is to interest-rate changes. A mere one percent rise in interest rates will cause a bond with a maturity of 25 years to fall about 12 percent in value.

The Wells Fargo salesman said, "You can't lose money on Government-guaranteed bonds." That's only partly true. While some bonds are Government-guaranteed, that simply means the bonds will be redeemed at their stated value when they mature. It doesn't mean that a mutual fund that invests in them can't decrease in value if interest rates change.

More than a dozen of the salespeople suggested that insurance from the Securities Investor Protection Corp., or SIPC, was just as good as Federal Deposit Insurance Corp. (FDIC) insurance. In fact, the SIPC insures brokerage accounts for up to $500,000 each, but pays off only if the brokerage firm goes bankrupt. The SIPC doesn't insure the performance of investments.

At Union Bank in Los Angeles, a saleswoman skipped mutual funds altogether. She first tried to sell our reporter an annuity, an insurance contract that promises a payment or series of payments at some future date, usually at retirement. When the reporter hesitated, the saleswoman phoned a colleague in another office and handed over the receiver. That salesman pitched a unit investment trust, an investment that's something like a mutual fund but that usually carries a higher commission.

Of the 40 salespeople who offered investment advice, only eight, in our judgment, made a credible effort to explain why they recommended what they did. Some others couched their advice in investment jargon that a customer with no background in finance would have been hard-pressed to understand. At United Jersey Bank in New Jersey, for example, a salesman tossed out such terms as "inverted yield curve," "basis points," "yield to maturity," "long hedge," and "fundamental analysis."

Most of the salespeople either skipped over or downplayed their commissions, which often take four to five percent off the top of a typical mutual-fund investment. Once again, only eight of the 40 salespeople we encountered outlined the fees in a manner that we judged complete and easily understood.

Profiting from confusion

Americans place a high degree of trust in their banks, largely because the FDIC guarantees bank account balances up to certain limits. But a 1993 survey by the Securities and Exchange Commission found that only 33 percent of the consumers questioned knew that money-market mutual funds sold by banks are not protected by FDIC insurance. And 28 percent thought that all mutual funds sold by banks are just as safe as deposits with FDIC insurance. Another 17 percent weren't sure whether bank mutual funds were insured or not. (They aren't. It's possible, if unlikely, to lose every cent that you put into a mutual fund, whether you bought it at a bank or elsewhere.)

It's not surprising that the public is confused, given the expansion of bank services in recent years. Until 1987, banks were mainly limited to taking deposits, paying interest on those deposits, and making loans. Then the Government began to allow banks to sell financial products such as stocks, bonds, annuities, and mutual funds.

Since then, banks have been starting and selling mutual funds at a rapid pace. BayBanks, Inc., of Boston, launched a family of mutual funds at the beginning of 1993, and by fall had attracted over $1-billion in assets. Mellon Bank of Pittsburgh announced in December that it would acquire the $80-billion Dreyfus Corp. mutual-fund company.

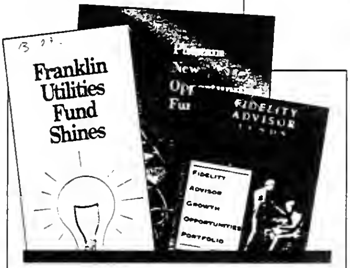
One reason for the banks' interest in funds is that tightened Federal rules on lending and increased capital requirements have forced them to look for sources of revenue other than making loans. At the same time, low rates on certificates of deposit have led to an exodus of depositors' money from banks. Nearly a third of all the money invested in CDs in 1990 has since left—a net loss of $191-billion in 1992 and $84-billion in 1993. Banks that sell mutual funds can keep some of that money from leaving, and they may be able to sell those customers CDs again if interest rates rise.

Growth industry Banks currently offer more than 1150 mutual funds with nearly $200-billion in assets. That's up from 213 funds and $35-billion just five years ago.

Enter the regulators

No branch of the Federal Government has been eager to claim jurisdiction over bank sales of uninsured investments. The Securities and Exchange Commission, which oversees other types of mutual funds, hasn't claimed direct regulatory power over those sold by banks. The FDIC and the Comptroller of the Currency both say their main concern is that banks not imply that their mutual funds and other investments are FDIC-insured.

There are signs that the Government may be waking from its regulatory slumber. Last November, President Clinton proposed a plan to consolidate oversight of the banking industry under a single Federal board, rather than the four agencies that currently share responsibility. Lax regulation of bank sales of in-



Game of percentages Fund companies must follow strict rules in quoting their past returns to potential investors. Not so the bank salespeople we encountered. Some took the liberty of writing the percentage rates they predicted on the fund literature they gave our reporter.

✓ Quart of milk
✓ Loaf of bread
✓ Mutual fund
Bank South Corp. of Atlanta, which operates banking outlets in stores like Kroger and Piggly Wiggly, has announced plans to sell mutual funds at its supermarket locations.

vestment products was cited as one reason for such a move.

The FDIC last summer issued an "advisory" to banks on mutual-fund sales. But the advisory, and similar guidelines from the Comptroller of the Currency, are simply advice, not rules. They have been widely ignored by the banks.

The Comptroller's guidelines call for banks to make a "conspicuous disclosure" in a prospectus or advertisement that mutual funds sold by the bank do not have FDIC insurance. Only seven of the salespeople we encountered, however, mentioned that the funds they sold were not bank deposits or were not FDIC insured.

Legislation to rein in the banks has been introduced by Henry Gonzales, D-Tex., chairman of the House Banking Committee. He cited as an example of the potential for abuse the Lincoln Savings & Loan scandal of 1989. It involved thousands of people, most of them elderly, who bought uninsured bonds they believed to be federally insured because the bonds were sold inside the bank. When the savings and loan was taken over by the Government, more than 23,000 customers were left holding $255-million in worthless bonds.

Investigators found that tellers at Lincoln Savings & Loan received bonuses for recommending uninsured bonds to customers and for meeting the sales quotas established at each branch. Customers were not told that the bonds were being used to finance real-estate ventures that entailed considerable risk.

The House proposal would require banks to sell uninsured products in a separate part of the bank. Currently, the regulations merely require them to comply "to the extent permitted by space and personnel considerations." Few of the banks CU visited segregated their mutual-fund operations. Indeed, most of them placed fund representatives in prominent locations, such as near the entrance or the tellers' line.

At some banks we visited, lobbies were festooned with mutual-fund advertisements. The small Wells Fargo branch at the corner of 6th and Grand in downtown Los Angeles featured more than 20 large hanging signs advertising mutual funds. Wells Fargo customers can even make some mutual-fund transactions through the bank's 1700 automated teller machines.

At several banks, our reporter overheard salespeople calling customers whose CDs were about to expire. Those customers were urged to switch their CDs to the bank's mutual funds or other investments. A salesman at a California bank boasted, "When I tell them the kind of return they could get with mutual funds, their eyes pop out."

Marketing efforts that target CD customers "can lead to abuse and therefore are of special concern," says the FDIC. The practice of calling people with maturing CDs to sell them other investments would be curtailed under the Gonzales bill. Prior written consent from the customer would be required before information about his or her accounts could be released without a court order.

The bill would also prohibit tellers from making unsolicited referrals to bank customers. According to the Consumer Bankers Association, a banking-industry trade group, tellers are often given incentives for referring depositors to the investment salespeople. Such incentives may include cash or extra vacation time, according to another source.

Customers usually aren't told whether the salesperson sitting in their bank's lobby works for the bank itself, a subsidiary of the bank, or an outside firm. If those customers buy a fund, their monthly statements may carry the bank's name, but the bank itself may have nothing to do with the investment except to collect a commission.

A bank may not only give an outside brokerage firm space in its branches, it may give the firm access to the bank's customer file, including the expiring CD lists. Bringing in outsiders who are not directly accountable to the bank creates the greatest chance for abuse. A branch manager at a Chicago bank, who asked that his name be withheld, told our reporter that no fewer than 12 brokers had come and gone from his branch during the previous 14 months. "The brokers are on commission, and my customers are marks to them," the manager said. "They don't monitor the customers' portfolio, except to try to generate another commission." ■

ADVICE ON ADVISERS

WHERE TO FIND INVESTMENT HELP

If you are planning to invest in mutual funds for the first time, your best bet is to educate yourself in the basics of investing, not to put your trust or your money in the hands of someone billed as an "investment adviser." In particular, we think you should focus on no-load mutual funds, the kind that are sold directly to investors without any costly sales commissions.

Information on mutual-fund investing is widely available. CONSUMER REPORTS published its most recent Ratings of funds in May (stock funds) and June (bond funds) 1993. Other magazines, such as Business Week, Forbes, and Money, also publish fund data, as do newspapers such as The Wall Street Journal and Barron's. Consumer Reports Books will publish a basic guide for fund investors, The Consumer Reports Mutual Funds Book, in May.

If you find that you need more help in choosing funds, don't sign up with the first adviser you encounter. Sound investment advice may well be as close as your neighborhood bank, but how can you tell?

Unfortunately, the fact that your bank may call its salesperson a financial planner means little. Anyone can hang out a financial planner shingle and offer investment advice. Seven of the salespeople we interviewed claimed to be Certified Financial Planners, which means that they have passed a course of study and received a certificate. Interestingly, none of the seven were among the group of salespeople whose recommendations we would consider appropriate.

Good financial planning should start with a written list of your current assets, debts, and income. The adviser should ask about your goals: when you'd like to retire and with what level of income, how you plan to finance your children's education, your tax situation, and so on.

With those factors in mind, the adviser can present a variety of investments with varying risk levels. He or she should be willing to explain each of them to your satisfaction and to let you choose what's best for you.

Insurance agents, lawyers, accountants, and tax preparers may do financial planning. Speak to several before you hand over any money. Shun those who want you to decide immediately. And don't rely on oral representations—get everything in writing.

If you want to pay for investment advice, consider hiring a fee-only financial planner. Such planners charge by the hour and don't make money from commissions. That doesn't mean their advice will always be better, but at least they won't have a vested interest in selling you the products that make them the most in commissions.

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U.S. HOUSE OF REPRESENTATIVES

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 4, 1994

Michael E. Bleier
General Counsel
Mellon Bank, N.A.
One Mellon Bank Center
Pittsburgh, PA 15258-0001

Re: Mellon Bank, N.A., Greensburg, PA - Control No. 93-NE-08-043
Mellon Bank (DE), N.A., Wilmington, DE - Control No. 93-NE-08-044
Operating Subsidiary Notice - Mellon/Dreyfus Acquisition

Dear Mr. Bleier:

This letter responds to your notification, on behalf of Mellon Bank, N.A. and Mellon Bank (DE) (collectively, the "Bank"), of the Bank's intent to establish certain operating subsidiaries (collectively, the "Subsidiaries") to acquire most of the assets, operations, and activities of The Dreyfus Corporation. Following the acquisition, the Subsidiaries primarily will engage in investment advisory, brokerage and administrative services to the Dreyfus family of mutual funds. The Subsidiaries will not act as distributor of the mutual funds. In addition, the Bank proposes to have the Subsidiaries engage in certain other activities unrelated to mutual funds which are permissible for national banks and their operating subsidiaries, including investing and selling certain precious metals to customers; holding loans; receiving and passing payments to the parent corporation; and selling variable annuities as agent from a place of under 5000 inhabitants.

The Bank's notification was filed with the Office of the Comptroller of the Currency ("OCC") on December 30, 1993, pursuant to 12 C.F.R. § 5.34. As provided in section 5.34, the OCC extended its thirty-day review period since the Bank's proposal raised issues which required additional information and time for analysis. The OCC reviewed the Bank's proposal to determine if the proposed activities were legally permissible for national bank operating subsidiaries and to ensure that the proposal was consistent with prudent banking principles and OCC policy. On February 23, 1994, the OCC published a summary of the Bank's proposed acquisition in the Federal Register, affording interested persons an opportunity to submit comments. See 59 Fed. Reg. 9017 (1994). The Federal Register notice also requested comments on another pending operating subsidiary notice. The time for filing comments on both notices expired on March 28, 1994, and the OCC has considered all comments received.

In response to the request for comments, the OCC received a total of thirty-six comments with thirty-one commenters supporting the Bank's proposal. The majority of the comments came from community groups favoring approval of the Bank's proposal based primarily on the Bank's demonstrated commitment to the community and the expectation that the acquisition would result in customers having greater and easier access to a wide range of banking and investment products. Commenters stated this would particularly benefit persons with fixed incomes and limited mobility. Various bankers and trade associations provided favorable comments focusing on the legal precedents for approval, the changing nature of banking, customer protection matters, and maintaining bank competitiveness. Several commenters urged against adopting regulatory conditions that would unfairly burden banks relative to other participants in the mutual funds industry. The OCC received five comments critical of the Bank's proposal. Two of the comments raised general concerns about bank participation in mutual fund activities and the other three comments discussed individual complaints based on alleged age discrimination in employment by an ex-employee, the sale of property by another bank acquired by the Bank, and a loan made by the Bank for the establishment of an employee stock ownership plan.

Based on the information provided in the Bank's notification letter dated December 30, 1993, accompanying legal memorandum and other written materials enclosed therein, subsequent materials listed in footnote one,[1] information provided by commenters, and the OCC's analysis, we conclude that the proposed activities are permissible for national banks and their operating subsidiaries and are consistent with prior opinions of the OCC. Accordingly, the Bank may implement its proposal pursuant to 12 C.F.R. § 5.34 based on the facts as described and in accordance with the submitted materials. This letter also subjects the Bank and the Subsidiaries to all the conditions set forth in this letter.

The Bank's Proposal

The Bank proposes to establish a wholly-owned operating subsidiary, XYZ Subsidiary, to facilitate the acquisition of most of the assets, operations and activities of The Dreyfus Corporation ("Dreyfus").[2] XYZ Subsidiary will merge with Dreyfus and Dreyfus will

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[1] Letter from Michael E. Bleier to Michael Tiscia dated March 4, 1994; Letter from Michael E. Bleier to Michael Tiscia dated March 4, 1994 (second letter); Letter from Michael E. Bleier to Suzette Greco and Ann Jaedicke dated March 4, 1994; Letter from Michael E. Bleier to Michael Tiscia dated March 15, 1994; and the Policy Statement on Mutual Funds dated April 21, 1994 (revised). For purposes of this letter, the term "Notification" refers to each of these items as well as the Bank's notification letter, accompanying legal memorandum and other written materials enclosed therein.

[2] The Dreyfus Corporation is a corporation organized and existing in good standing under the laws of the State of New York, with its principal offices located in New York, New York. Dreyfus has operated under the Dreyfus name since 1951 and has been publicly

continue as the surviving corporation. Dreyfus and its current subsidiaries will be divided into four groups after the acquisition: (1) those that will become operating subsidiaries of Mellon Bank, N.A.; (2) those that will become operating subsidiaries of Mellon Bank (DE);[3] (3) those that will become nonbank subsidiaries of Mellon Banking Corporation ("MBC"), the parent corporation of the Bank; and (4) those that will be liquidated or divested. The Bank's notice and this letter only relate to the proposed subsidiaries as listed in groups (1) and (2).[4] The acquisitions are pursuant to an Agreement and Plan of Merger among MBC, Mellon Bank, N.A., XYZ Subsidiary and Dreyfus.[5]

The Subsidiaries listed in groups (1) and (2) above will be chartered under the laws of either New York or Delaware and will have offices in New York City and several other locations. None of the offices of the Subsidiaries will receive deposits, pay checks or lend money. The Dreyfus Corporation is located at 200 Park Avenue, New York, New York, and will continue to operate from that location. Following the merger, the Dreyfus management team and the Dreyfus fund managers will remain in place, and the Dreyfus name will be retained for the mutual funds it manages.[6] The Bank represents that no director, officer or employee

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owned since 1965. Dreyfus serves primarily as an investment advisor and manager of mutual funds and is the sixth largest mutual fund company in the United States. Dreyfus also acts as the holding company for several other entities.

[3] Dreyfus Service Organization, Inc. is the only current Dreyfus subsidiary proposed to become an operating subsidiary of Mellon Bank (DE).

[4] The current subsidiaries of Dreyfus that will continue as subsidiaries of the post-merger Dreyfus are: The Dreyfus Consumer Credit Corporation; Dreyfus-Lincoln, Inc.; Dreyfus Management, Inc.; Dreyfus Personal Management, Inc.; Lion Management, Inc.; Dreyfus Precious Metals, Inc.; Dreyfus Service Corporation; Seven Six Seven Agency, Inc.; and Dreyfus Service Organization, Inc. The incoming materials provide descriptive details on the activities of each of these entities. For purposes of this letter, use of the name "Dreyfus" encompasses the holding company and these subsidiaries, unless otherwise noted. All of these entities will be bank operating subsidiaries after the merger.

[5] MBC will issue shares of its common stock for each share of Dreyfus common stock. MBC will account for the transaction as a pooling of interests. The proposed merger will have a positive impact of the capital position of the Bank. The Bank notes that the principal reasons for establishing Dreyfus as a subsidiary of the Bank, rather than a subsidiary of MBC, were to provide this major increase to the Bank's capital position and to supplement the Bank's earnings with Dreyfus' earnings.

[6] The management of the Bank has committed that Dreyfus will operate as an independent entity for at least two years subsequent to the acquisition. The Bank will be accountable for the operations of Dreyfus, as it is for all of its operating subsidiaries. MBC will provide oversight and review of the Dreyfus operations by participation on an executive

of the Subsidiaries will serve as a director, officer or employee of any of the Dreyfus family of mutual funds.

The Subsidiaries will be subject to substantial regulatory requirements under the federal securities laws, applicable state laws and the Rules of Fair Practice of the National Association of Securities Dealers, Inc. ("NASD"). In particular, The Dreyfus Corporation and Dreyfus Management, Inc. will continue as registered investment advisors under the Investment Advisors Act of 1940 and under all applicable state investment advisory laws. Dreyfus Service Corporation will continue as a registered broker-dealer under the Securities Exchange Act of 1934 and under all applicable state broker-dealer laws. It also will continue as a member in good standing of the NASD. In addition, as national bank operating subsidiaries, the Subsidiaries will be subject to examination and supervision by the OCC.

Under the Bank's proposal, the Subsidiaries will engage in the current activities of Dreyfus, with various exceptions. The primary business of Dreyfus is the provision of investment advisory and administrative services to registered open-end investment companies (mutual funds).[7] Dreyfus provides services to approximately 130 of its own mutual funds (the "Dreyfus Funds" or "Funds"), which have approximately $80 billion in assets. Approximately 54% of the assets are in money market funds, 34% in bond funds and 12% in equity funds. Dreyfus also provides investment advisory services to closed-end funds, individuals and institutional investors.

Each of the Dreyfus Funds is registered as an investment company under the Investment Company Act of 1940 ("1940 Act") and under state securities laws, as applicable. Each Fund is governed by a board of directors consisting of a minimum of three directors subject to 1940 Act requirements concerning independence.[8] Shares of each Fund are registered with the Securities and Exchange Commission ("SEC") under the Securities Act of 1933 as

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committee. The Bank represents that Dreyfus will establish an Executive Committee responsible for Dreyfus' operations, which will be composed of two representatives from MBC and two from Dreyfus. The current Chief Executive Officer and President of Dreyfus will remain in place during the two year period. The current membership of the Dreyfus Board of Directors will remain the same.

[7] As provided in the Bank's notice, Dreyfus also has seventeen financial service centers located throughout the United States. These centers provide various services, including selling shares of Dreyfus Funds solely on an agency basis. The Subsidiaries will continue these activities after the acquisition.

[8] Section 10 of the 1940 Act basically provides that at least forty percent of the directors on the board must be independent, unless certain affiliated relationships exist in which case a majority of the directors must be independent. See 15 U.S.C. § 80a-10. The Bank represents that the Dreyfus Funds will have boards of directors independent from the Bank and the Subsidiaries.

required. All disclosure and marketing materials relating to the Funds, including each Fund's prospectus, will comply with applicable requirements under the 1940 Act, the Securities Act of 1933, applicable state securities laws and federal banking laws.

The Subsidiaries will continue to provide investment advisory services to the Dreyfus Funds as well as to, among others, corporate retirement plans, individuals, foundations and endowments. One or more of the Subsidiaries will act as direct advisor to the Dreyfus Funds. While Dreyfus currently acts as distributor of the Funds, prior to the time the acquisition is consummated Dreyfus will resign as distributor. The respective boards of directors of the Funds will contract with an independent third party to act as distributor.[9]

In conjunction with the advisory services, the Subsidiaries will provide various administrative services to the Dreyfus Funds. For example, such services may include maintaining and preserving Fund records, computing net asset value and other performance information regarding the Funds, preparing and filing with the SEC and state securities regulators registration statements and other required materials; preparing and filing tax returns, providing office facilities for the Funds, and coordinating communications and activities between the investment advisor and other service providers. The Bank represents that these are normal administrative services substantially similar to those recently approved by the Federal Reserve Board in connection with the Mellon Bank Corporation's acquisition of The Boston Company. See Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993). The Subsidiaries will receive a fee for providing the advisory and administrative services consistent with 1940 Act requirements and general industry practices.

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[9] The party specifically identified as the distributor will serve as the intermediary between the Funds and purchasers of Fund shares. The independent distributor will be a "principal underwriter" for purposes of the 1940 Act. As provided by the Bank, the independent distributor likely will be responsible for (1) entering into distribution agreements with the Dreyfus Funds; (2) being named as the distributor in all Fund prospectuses and sales literature; (3) confirming to investors or broker-dealers all sales of Dreyfus Funds shares with a confirmation complying with Rule 10b-10 under the 1940 Act; (4) providing the required seed money for any new funds; (5) entering into agreements with broker-dealers selling the Dreyfus Funds; (6) collecting front end sales charges from broker-dealers or investors; (7) advancing commissions to broker-dealers; (8) receiving and transmitting that portion of 12b-1 payments that will be paid to broker-dealers as sales and maintenance commissions, and entering into 12b-1 agreements with broker-dealers, banks and others as contemplated by Rule 12b-1; (9) collecting back-end sales charges from redeeming shareholders; (10) paying the costs of printing and distributing prospectuses to potential investors; and (11) providing other regulatory/administrative services that are typical for a distributor. The distributor will receive a fee for its distribution activities consistent with industry practice.

Similar to current Dreyfus activities, the Subsidiaries also will engage in securities brokerage activities on behalf of their clients. The Subsidiaries may provide shareholder services and sell Fund shares, solely on an agency basis, at financial service centers throughout the United States. The Bank represents that the Subsidiaries will not engage in underwriting or dealing. The Subsidiaries also will not sponsor or organize new mutual funds for the Dreyfus Funds family.[10] The compensation received by the Subsidiaries for brokerage services will be consistent with that customarily received by an agent and not that of a principal or dealer.[11]

In an effort to minimize any potential safety and soundness concerns, address consumer protection issues and prevent conflicts of interest, the Bank represents that the Bank and its subsidiaries will adopt a Policy Statement on Mutual Funds prior to the acquisition.[12] The Policy Statement builds upon the Bank's existing comprehensive policies governing sales of nondeposit investment products. Specific areas covered by the Policy Statement include suitability requirements, procedures to ensure that the customer understands that mutual funds are not FDIC-insured or bank obligations, differentiation between names of mutual funds and the Bank's name, use of signs to illustrate the differences between bank obligations and mutual fund shares, and independence of the Funds and the Funds' boards of directors. As provided in the Policy Statement, all transactions between the Bank and the Subsidiaries will be subject to Sections 23A and 23B of the Federal Reserve Act without giving effect to the exemption for bank subsidiaries. See 12 U.S.C. § 371c(b)(2)(A).[13] The Bank has acknowledged that the voluntary commitments set forth in the Policy Statement

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[10] The independent distributor may organize new mutual funds which the Subsidiaries subsequently may advise or administer. The Bank represents that it will not provide seed capital to fund these new mutual funds.

[11] The Bank anticipates that trades for the Dreyfus Funds will be executed through broker-dealers not affiliated with the Bank or the Subsidiaries. Broker-dealers will be selected to ensure best execution of such trades. These trades currently are executed for the Dreyfus Funds by unaffiliated broker-dealers. In the event an affiliated broker-dealer were used, the relationship would be governed by Section 17(e) of the 1940 Act and Rule 17e-1 concerning transactions between affiliated parties.

[12] The Bank represents that the Policy Statement will apply to Dreyfus as of the date Dreyfus becomes an operating subsidiary of the Bank.

[13] We also note that under Sections 23A and 23B of the Federal Reserve Act, the Bank considers the Funds "affiliates" of the Bank and thus subject to various requirements enacted to protect banks from potential abuses in financial transactions with affiliated companies. See 12 U.S.C. § § 371c and 371c-1.

could be formal conditions enforceable by the OCC.[14] See Letter from Mellon Banking Corpcration and The Dreyfus Corporation to The Honorable John D. Dingell, Committee on Energy and Commerce dated February 18, 1994. Compliance with the Policy Statement is imposed as a condition of regulatory approval in the "Conclusion" section and a copy of the Statement is attached to this letter for reference. In addition, the Bank and the Subsidiaries are subject to the Interagency Statement on sales of nondeposit investment products which is discussed in the subsection of this letter entitled "Application of the Interagency Statement."

In addition to the mutual fund-related activities discussed, the Subsidiaries also will engage in several other activities generally permissible for national banks and their operating subsidiaries. Certain Dreyfus subsidiaries being acquired by the Bank currently engage in these activities.[15] These other activities include: investing and selling certain precious metals to customers; holding loans; receiving and passing payments to the parent corporation; and selling variable annuities as agent from a place of under 5000 inhabitants.

We expect that the Bank and the Subsidiaries will conduct their operations in accordance with all applicable laws and regulations and in a prudent manner, consistent with safe and sound banking practices.

Legality of Proposed Activities

Permissible Banking Activities

The National Bank Act provides that national banks shall have the power:

> To exercise ... all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.

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[14] The Bank represents that it will not make any changes in the Policy Statement without prior notice to the OCC and the Federal Reserve Board. The Bank states it will not make the change if notified of objections by either agency within thirty days of the notification.

[15] As provided in the Bank's notice, however, two of the subsidiaries being acquired currently are inactive: Dreyfus Personal Management, Inc., which offers discretionary advisory services primarily to individuals, and Lion Management Inc., which acts as a commodity pool operator and commodity trading advisor for limited partnerships. While these activities generally are permissible, the Bank agrees it will give advance notice to the OCC of any decision to activate these subsidiaries after the acquisition. The Bank should submit a notice pursuant to 12 C.F.R. § 5.34.

12 U.S.C. § 24(Seventh). The OCC has taken the position that Section 24(Seventh) grants broad powers for banks to engage in the business of banking, including the specifically recited powers and such other incidental powers that are reasonably necessary to perform the business of banking as a whole. See Interpretive Letter No. 494 (December 20, 1989), reprinted in [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,083 (extensive analysis concluding that such a broad view is supported by statutory construction, legislative history, case law, general circumstances, and commentators).[16] The courts have used various tests to determine whether banking activities are within the intended scope of Section 24(Seventh) and have found that permissible incidental activities include those that are similar to an express power, relate to an express power, resemble traditional banking functions or constitute financial activities. See Letter No. 494, supra, at 11-16. The five enumerated powers are examples of banking powers, but not the exclusive list. Many other activities, including those proposed by the Bank, also are inherent parts of the business of banking.[17] We find that the proposed activities for the Subsidiaries are within the scope of banking activities previously considered and found permissible by the OCC, other regulatory agencies and the courts.[18]

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[16] As one commentator has noted:

> whatever may be the legal rule as to business corporations, or municipal corporations, it seems clear that National Banks are not confined to the powers specified in the National Bank Act and those necessary to carry out those specific powers; and that in the case of National Banks ... the test is not whether a power is necessarily incident to one of the specific powers granted, but whether it is properly implied from all of the terms used, in light of the general intent and purpose of the statute.

Trimble, The Implied Power of National Banks to Issue Letter of Credit and Accept Bills, 58 Yale L.J. 713, 721 (1949).

[17] See New York State Ass'n of Life Underwriters v. New York State Banking Dept., 598 N.Y.S. 2d 824 (N.Y. App. Div., 1993), aff'd, – N.Y. – (March 30, 1994) (court found similar incidental powers clause of New York banking law permitted banks to expand banking services over time consistent with evolving business practices and customers' needs).

[18] In addition, the OCC has long recognized its authority to establish operating subsidiaries as an inherent part of the business of banking. See 31 Fed. Reg. 11459 (Aug. 31, 1966). Operating subsidiaries enable banks to use a different organizational structure to conduct permissible activities. The OCC has provided by regulation that national banks may choose to engage in permissible activities by means of an operating subsidiary. 12 C.F.R. § 5.34. The operating subsidiary is subject to OCC examination and supervision and to the same banking laws and regulations as the parent bank unless otherwise provided by statute or regulation. Id. Thus the Bank has the authority to establish the Subsidiaries to engage in the proposed activities as long as the activities are permissible.

Investment Advisory Services

The OCC has firmly established that national banks and their subsidiaries have the authority to provide investment advice as part of or incidental to the business of banking. See e.g., OCC Letter from Frank Maguire (April 15, 1994); Interpretive Letter No. 622 (April 9, 1993), reprinted in Fed. Banking L. Rep. (CCH) ¶ 83,504; Interpretive Letter No. 367 (August 19, 1986), reprinted in [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,537; Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (September 23, 1983), reprinted in Fed. Banking L. Rep. (CCH) ¶ 99,732. Investment advice also is authorized by trust powers provisions in 12 U.S.C. § 92a. The courts have confirmed that bank holding company subsidiaries may act as investment advisors. See Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S. 46 (1981) ("ICI"); Securities Industry Association v. Board of Governors of the Federal Reserve System, 821 F.2d 810 (D.C. Cir. 1987), cert. denied, 484 U.S. 1005 (1988) ("NatWest").

Likewise, the OCC has permitted national bank subsidiaries to offer investment advice to customers and simultaneously act as investment advisor to the same mutual fund. See Interpretive Letter No. 403 (December 9, 1987), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,627. In finding that a bank holding company may serve as investment advisor to a mutual fund, the Supreme Court has recognized that the functions of an investment advisor include management activities:

> The principal activity of an investment advisor is to manage the investment portfolio of its advisee -- to invest and reinvest the funds of the client. Banks have engaged in that sort of activity for decades. As executor, trustee, or managing agent of funds committed to its custody, a bank regularly buys and sells securities for its customers.

ICI, 450 U.S. at 55; see also OCC Letter from Daniel L. Pearson (January 13, 1993) (approving operating subsidiary to enter into a partnership that will act as a mutual fund manager) [hereinafter the "Pearson Letter"]; OCC Letter from William B. Glidden (January 14, 1988) (national bank investment advisors manage and supervise the investment and reinvestment of cash, securities or other properties comprising the assets of the mutual funds) [hereinafter the "Glidden Letter"].

Brokerage Services

Similarly, numerous OCC and court opinions confirm the long established power of banks and their subsidiaries to perform brokerage services for their customers. See e.g., Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207 (1984) ("Schwab"); Securities Industry Association v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), aff'd per curiam, 758 F.2d 739 (D.C. Cir. 1985), cert. denied,

474 U.S. 1054 (1986) (brokerage issue); Interpretive Letter No. 494, supra; In re Security Pacific National Bank (August 26, 1982), reprinted in [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284. The authority of banks to provide brokerage services is within the business of banking as contemplated in 12 U.S.C. § 24(Seventh) and is expressly recognized by the language of the Glass-Steagall Act.[19] The OCC has permitted securities brokerage activities by national bank subsidiaries including the purchase and/or sale, as agent, of shares in mutual funds. See e.g., Interpretive Letter No. 622, supra; Interpretive Letter No. 403, supra; Interpretive Letter No. 386 (June 19, 1987), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610; Interpretive Letter No. 363 (May 23, 1986), reprinted in [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,533. Further, full-service brokerage, the combination of investment advisory and brokerage services, in the same national bank subsidiary previously has been approved. Interpretive Letter No. 403, supra; Interpretive Letter No. 386, supra.

An integral part of full-service brokerage is the ability to attract customers by advertising and marketing the services and products available. The Supreme Court in considering a contrary state law found that under its incidental powers a national bank can advertise any service that the bank lawfully offers. See Franklin National Bank v. New York, 347 U.S. 373, 377-78 (1954) ("Modern competition for business finds advertising one of the most usual and useful of weapons."). The District of Columbia Circuit has recognized, albeit in a different context, that the selling of securities necessarily involves finding and soliciting buyers:

> [N]o sensible construction of the statute [Section 16 of the Glass-Steagall Act] could say that otherwise permissible selling activities cannot involve the solicitation of buyers. The seller's very purpose in engaging a selling agent and paying a commission is to require that agent's superior ability to place the product with buyers. If placement of the product with buyers did not require any solicitation of buyers, no rational business would pay another firm to do what it could without cost to itself: passively wait for orders.

Securities Industry Association v. Board of Governors of the Federal Reserve System, 807

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[19] While Section 16 of the Glass-Steagall Act places limitations on certain securities activities of banks, this provision specifically preserved banks' power to broker such securities:

> The business of dealing in securities and stock by the [bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock....

12 U.S.C. § 24(Seventh). Further discussion of Section 16 of the Glass-Steagall Act is contained in the subsection of this letter entitled "Glass-Steagall Act."

F.2d 1052, 1062 (D.C. Cir. 1986), cert. denied, 483 U.S. 1005 (1987) ("Bankers Trust II"). By analogy to the Supreme Court's Schwab decision approving brokerage operations, the court noted that banks must advertise to let customers know such services are available:

> It would strain credulity to assert that the circulation of a brochure or the running of an advertisement to publicize the availability of these services would mean that the brokerage services performed are now barred since no longer performed solely upon the order of the customer.

Id. at 1061.[20]

Likewise, the OCC previously has acknowledged the need of national banks to publicize banks' investment advisory, brokerage and administrative services relating to mutual funds. See Interpretive Letter No. 622, supra (making lobby materials available on services, placing newspaper advertisements, sending statement stuffers and providing other descriptions of the variety of services that are available); Pearson Letter, supra (as mentioned in the incoming letter, preparing and distributing explanatory materials concerning the investment portfolios); Glidden Letter, supra (furnishing prospectus or sales literature on funds upon request, having advertisements and brochures listing mutual funds available through the bank and the bank's services); Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (September 23, 1983), reprinted in Fed. Banking L. Rep. (CCH) ¶ 99,732 (generating and distributing an advisory newsletter with recommendations for the purchase of specific securities); see also Interagency Statement, which acknowledges banks advertise and market uninsured investment products to customers and provides for full disclosure.

Based on existing judicial and agency precedent, we find that providing advertising and marketing support relating to mutual funds is an integral part of permissible brokerage and advisory services and thus is part of or incidental to the business of banking under the National Bank Act. The federal securities laws and regulations prohibit materially misleading or inaccurate representations in connection with offers and sales of mutual funds and heavily regulate the content of advertising, marketing materials, and other communications to potential purchasers of mutual fund shares. The federal banking

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[20] We also note that nothing in the statutory language of Section 16 of the Glass-Steagall Act suggests that advertising and marketing activities are prohibited. See 12 U.S.C. § 24(Seventh). Although a recent decision by the Federal Reserve Board approving certain mutual fund-related activities by a nonbanking subsidiary of a bank holding company recited certain representations regarding the limited nature of advertising and marketing in which the applicant proposed to engage, the Board did not find that advertising and marketing are prohibited by the Glass-Steagall Act. See Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993).

regulators also have adopted an Interagency Statement which sets forth additional provisions governing advertising and marketing by federally insured financial institutions. Further, consistent with the Bank's Policy Statement on Mutual Funds, advertising and other marketing by the Subsidiaries of the Dreyfus Funds will include complete and accurate disclosure. Accordingly, ample regulatory safeguards will apply to any advertising and marketing conducted by the Subsidiaries to address any potential safety and soundness concerns and to provide customer protections.

Administrative Services

In conjunction with investment advisory and brokerage services, the OCC also has permitted national banks and their operating subsidiaries to provide a variety of administrative and shareholder services with respect to the operation of a mutual fund. See e.g., Glidden Letter, supra (providing various administrative services and acting as investment advisor to mutual funds); Interpretive Letter No. 386, supra (providing recordkeeping, accounting, and other services in connection with 12b-1 and similar plans); Interpretive Letter No. 332 (March 8, 1985), reprinted in [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,502 (recordkeeping, order execution functions, and shareholder information). These administrative functions are incidental to the related provision of investment advisory and brokerage services.

Likewise, the Federal Reserve Board recently has approved a nonbanking subsidiary of a bank holding company to provide various administrative and advisory services to mutual funds. See Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993). The Fed approved administrative activities substantially similar to those proposed by the Bank.[21] The Fed reasoned that such administrative activities generally are ministerial or clerical in nature and do not impart impermissible "control" or policy-making authority over the mutual fund. See id. at 10-11. As the Board noted, mutual funds are governed by a disinterested board of directors dictated by various independence requirements of the 1940 Act and ultimate control over the funds rests with the board of directors. Id. Accordingly, because the administrative services the Bank proposes to provide are substantially similar to those previously approved, we find such services are permissible.

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[21] The activities approved by the Fed included maintaining and preserving Fund records, computing net asset value and other performance information regarding the Funds, preparing and filing with the SEC and state securities regulators registration statements and other required materials; preparing and filing tax returns, providing office facilities for the Funds, and coordinating communications and activities between the investment advisor and other service providers. For a complete list of the activities approved see Appendix A of the Mellon decision.

The Glass-Steagall Act

Apart from the authorities discussed above allowing national banks and their operating subsidiaries to engage in the proposed activities as part of or incidental to the business of banking, we also have examined the Bank's proposal under the Glass-Steagall Act ("GSA" or the "Act").[22] While we concur with your conclusion that because the activities of the proposed Subsidiaries are lawful banking activities, a Glass-Steagall analysis is not required or even permissible under the Second Circuit's analysis in Securities Industry Association v. Clarke,[23] we find that even if the Glass-Steagall prohibitions were applied, the proposed activities are permissible.

The relevant language of Section 16 of the GSA generally prohibits national banks from "underwriting" or "dealing" in securities and stock. See 12 U.S.C. § 24(Seventh).[24] Neither the statute nor legislative history define the terms underwriting or dealing. Underwriting as commonly used, however, refers to the process by which newly issued securities are purchased by another firm for distribution and sale to investors. See Interpretive Letter No. 388 (June 16, 1987), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612; OCC Interpretive Letter No. 329, reprinted in [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499 (March 4, 1985).[25] Similarly,

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[22] The Glass-Steagall Act is the popular name for essentially four provisions in the Banking Act of 1933. Section 16 of the Act (12 U.S.C. § 24(Seventh)) places limits on national banks underwriting and dealing in securities and stock and prohibits national banks from purchasing or selling securities except upon the order and for the account of customers. Section 20 (12 U.S.C. § 377) prohibits Federal Reserve member bank affiliation with a company engaged principally in underwriting and other securities activities. Section 21 (12 U.S.C. § 378) prohibits organizations that are engaged in underwriting and other securities activities from simultaneously engaging in the business of receiving deposits. Section 32 (12 U.S.C. § 78), prohibits officer, director or employee interlocks between member banks and companies that are primarily engaged in the securities activities listed in section 20.

[23] 885 F.2d 1034 (2d Cir. 1989), cert. denied, 493 U.S. 1070 (1990) ("Clarke"). The court concluded that the bank's sale of mortgage pass-through certificates was encompassed within the power to carry on the business of banking under 12 U.S.C. § 24(Seventh). Id. at 1047. As such, the court upheld the Comptroller's determination that because the activity was an authorized banking activity the prohibitions of the Glass-Steagall Act did not apply. Id. at 1048.

[24] See supra footnote 19.

[25] Although the term underwriting may encompass a variety of activities, so-called "firm commitment underwriting" whereby one purchases an issue of securities from the issuer and then resells the securities to the public is recognized as the most common form of underwriting in the United States. See L. Loss, Fundamentals of Securities Regulation 77-

dealing in securities generally encompasses purchase and sale activities with respect to the securities of other issuers. See Interpretive Letter No. 388, supra. The Federal Reserve Board also has recognized that underwriting and dealing involve the banking entity's purchase of shares for its own account thereby incurring a principal risk. See Board of the Governors of the Federal Reserve System Letter, reprinted in [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 86,620 (June 27, 1986) [hereinafter the "Sovran Letter"]; see also Schwab, 468 U.S. at 218 n.18 (1984) (as underwriter and dealer, a security firm engages in buying and selling securities on its own account, thereby assuming all risk of loss).

The Bank has represented that the proposed Subsidiaries will not engage in underwriting or dealing in the shares of the Dreyfus Funds that they advise. The Subsidiaries will not purchase the shares for resale to customers and will have no indicia of record or beneficial ownership. Consequently, the Subsidiaries will incur no principal risk and have no potential for gain with respect to the fund shares. Accordingly, the proposed activities of the Subsidiaries are not prohibited by Section 16.

In contrast, Section 21 of the Act prohibits certain kinds of securities firms from engaging in banking activities.[26] Section 21 restricts any person or organization "engaged in the business of issuing, underwriting, selling, or distributing ... stocks, bonds, debentures, notes, or other securities" from receiving deposits. 12 U.S.C. § 378. Despite the different terminology the Supreme Court has held that Section 16 and Section 21 seek to draw the same line. Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137, 149 (1984) ("Bankers Trust I"). In considering the interplay between the two sections, the courts have found that Section 21 cannot be read to prohibit what Section 16 permits. See Bankers Trust II, 807 F.2d at 1057; ICI, 450 U.S. at 63. Thus finding that the proposed activities are permissible under Section 16 necessarily leads to the conclusion that they are not prohibited by Section 21. See Clarke, 885 F.2d at 1049.[27]

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85 (2d ed. 1988); see also Schwab, 468 U.S. at 217 n.17 (1984) (typically, the underwriter purchases securities from the issuer).

[26] Section 16 separates investment and commercial bank activities from the perspective of the commercial bank and Section 21 provides similar limitations from the investment bank's perspective. See Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137, 148 (1984) ("Bankers Trust I"); ICI, 450 U.S. at 63 ("[Section] 21 presented the converse situation of § 16 and was intended to require securities firms such as underwriters or brokerage houses to sever their banking connections.").

[27] Section 21's prohibitions are not triggered by the Bank's proposal. Assuming arguendo that the mutual funds are engaged in issuing, underwriting, selling or distributing securities, they are not receiving deposits. Likewise, while the Bank and the Subsidiaries may receive deposits, they are not engaged in issuing, underwriting, selling or distributing securities. The OCC and the FRB have indicated that a bank's sale of mutual funds as agent

The prohibitions in Section 20 of the Glass-Steagall Act on affiliations between national banks and companies engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities do not apply to the Bank's proposal. See 12 U.S.C. § 377.[28] The mutual funds are not "affiliates" of the Bank under 12 U.S.C. § 221a; 12 U.S.C. § 377. The common ownership and control required under the definition of an affiliate in Section 221a does not arise under the proposal. In fact, the Funds will meet the independence requirements from the Bank dictated by the 1940 Act, requiring that the Funds' boards of directors consist of a majority of persons who are not directors, officers, or employees of the Bank. See 15 U.S.C. § 80a-10(c). Because the Funds must operate under the control of their independent boards, the relationship with the Bank cannot be viewed as prohibited by Section 20. The OCC has previously concluded that the 1940 Act confers so much authority on the disinterested members of a fund's board that control of a fund by the investment advisor appears to be precluded as a matter of law. Decision of the Comptroller of the Currency to Charter J.& W. Seligman Trust Company, N.A., reprinted in [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,463 (February 4, 1983); see also Decision of the Comptroller of the Currency to Charter Dreyfus National Bank and Trust Company, reprinted in Fed. Banking L. Rep. (CCH) ¶ 99,464 (February 7, 1983); Mellon Bank Corporation 79 Fed. Res. Bull. 626 (April 21, 1993).

Likewise, the proposal will not result in any prohibited employee interlocks between the Bank and the mutual funds as prohibited by Section 32. Section 32 provides that no officer, director, or employee of any business organization primarily engaged in the "issue, flotation, underwriting, public sale, or distribution" of securities shall serve at the same time as an officer, director or employee of a member bank. See 12 U.S.C. § 78. The Bank has represented that no officer, director, or employee of the Bank will serve as such with respect to the mutual funds and no officer, director, or employee of the mutual funds will serve as such in the Bank. The directors, officers, and employees of the independent distributor also will not overlap with those of the Bank or the Subsidiaries. Thus there are no prohibited relationships under Section 32.

Given that the proposed activities are permissible as part of the business of banking, a subtle hazards analysis as often discussed in the GSA context is unnecessary. See Clarke, 885 F.2d

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does not constitute Glass-Steagall distribution, even if the bank also acts as the advisor and/or administrator to the funds. See 12 C.F.R. § 225.125; Glidden Letter, supra; Sovran Letter, supra; Interpretive Letter No. 332, supra. Moreover, the Bank has represented that Dreyfus will resign as distributor of the Dreyfus Funds and the boards of directors will appoint an independent third party as the named distributor.

[28] The Supreme Court has concluded that the term "public sale" in Section 20 refers to sales as an underwriter or dealer and not sales to the public as agent. See Schwab, 468 U.S. at 218.

1034.[29] Nonetheless, even applying a hazards analysis, the Bank's proposed activities are not prohibited by the GSA. In Investment Company Institute v. Camp, the Supreme Court found that Congress enacted the GSA to prevent the so-called "subtle hazards" that might arise when a commercial bank's promotional interest in the success of particular securities investments or in the activities of its securities affiliates[30] might interfere with the bank's ability to act as an impartial source of credit or to render disinterested investment advice. See 401 U.S. 617, 634 (1971).[31] Since Camp, the Supreme Court and other courts have discussed and limited the application of these subtle hazards in several decisions. Schwab, 468 U.S. at 220; ICI, 450 U.S. at 66; NatWest, 821 F.2d at 815. These decisions conclude that financial institutions involved in investment advisory activities to mutual funds, retail brokerage, and a combination of advisory and brokerage activities do not raise the subtle hazards of underwriting as identified in Camp. See id. Another court has explained that the subtle hazards analysis "catalogues the various conflicts of interest and dangers that may result from a commercial bank's dealing in 'particular' securities." Bankers Trust II, 807 F.2d at 1067. As in Camp, the obvious hazard is the investment of bank funds in speculative securities. See id. This hazard, however, is not an issue under the Bank's proposal. Since the Bank and the Subsidiaries will act only as agent and will not purchase the mutual fund shares as principal, the Bank's assets will not be at risk.

Unlike in Camp, the Bank is not proposing to engage in the Glass-Steagall prohibited securities activities of underwriting and dealing. The Bank's and the Subsidiaries' involvement with the mutual funds is distinctly different from that in the traditional underwriting context. Thus there is no promotional pressure to "hold and sell" the securities or "purchase and sell" the securities for their own accounts. See Camp, 401 U.S. at 630; Schwab, 468 U.S. at 220; see also NatWest, 821 F.2d at 816. The investment companies issuing and redeeming the mutual fund shares are entirely separate entities governed by independent boards of directors. While the Bank and the Subsidiaries perform services for the investment companies, they do not have an ownership interest in the Funds or control over the Funds' operations. Hence, the Bank and the Subsidiaries do not have the same pressure to make unsound loans or render biased investment advice.

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[29] See supra footnote 23 and accompanying text.

[30] In contrast to the proposed activities of the Subsidiaries, the securities affiliates referred to by the Court engaged in floating bond issues and underwriting stock issues. See Camp, 401 U.S. at 617. One effect of the GSA was to abolish these types of securities affiliates of banks. See id.

[31] The Court expressed deep concern with situations where banks were involved in the trading and ownership of speculative securities. See Camp, 401 U.S. at 616. The Court also identified other possible hazards that might arise when banks became involved in securities activities, including impairing public confidence in the bank, encouraging unsound loans to customers, and diminishing customer good will. See id. at 630-34.

Moreover, the Subsidiaries' proposed involvement with the mutual funds is analogous to activities already engaged in by national banks and their operating subsidiaries and found permissible by the OCC, other regulatory agencies and the courts. See e.g., Interpretive Letter No. 403, supra; Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (September 23, 1983), reprinted in Fed. Banking L. Rep. (CCH) ¶ 99,732; In re Security Pacific National Bank (August 26, 1982), reprinted in [1982-83 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284; see also NatWest, 821 F.2d at 816; Mellon Bank Corporation 79 Fed. Res. Bull. 626 (1993). None of these decisions found that the subtle hazards would preclude the proposed advisory, brokerage, and administrative activities.

Many of the hazards perceived by the court in Camp subsequently have been addressed by changes in regulation and market practice. For example, various disclosures and customer protections applicable to mutual funds are provided by the Interagency Statement and the Rules of Fair Practice of the NASD. Under sections 23A and 23B of the Federal Reserve Act, the Bank considers the Funds "affiliates" of the Bank and thereby the limitations on financial transactions between banks and their affiliates would apply. See 12 U.S.C. § § 371c and 371c-1. Moreover, the Funds themselves are registered as investment companies under the 1940 Act and subject to detailed requirements. The Bank also has made various representations concerning its relationship with the Funds that seem to meet the Congressional concerns voiced by the Camp court.[32] These kinds of changes minimize any risk of impairing public confidence in the bank or diminishing customer good will. Accordingly, we find it unlikely that the Subsidiaries' activities would implicate Glass-Steagall's subtle hazards, that adequate safeguards limit any such hazards from arising, and that, overall, the proposed activities are not prohibited by the GSA.

Other Proposed Activities Unrelated to Proposed Mutual Fund Activities

Several Dreyfus subsidiaries being acquired engage in other activities generally permissible for national banks and their operating subsidiaries. Based on the Bank's factual descriptions,

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[32] In particular, the Bank has represented that the Bank and/or the Subsidiaries will not (1) purchase shares of the Dreyfus Funds for their own accounts; (2) purchase shares of the Dreyfus Funds for any third party account over which they have discretionary authority except as authorized by the instrument, the beneficiaries of such account, court order or local law; (3) extend credit to the Dreyfus Funds; and (4) make a loan for the purpose of purchasing shares of the Dreyfus Funds. As discussed previously, the Bank and its subsidiaries have committed to adopting a Policy Statement on the sale of non-deposit investment products, including mutual funds, which incorporates, and in some respects goes beyond, current regulatory guidelines and Congressional proposals. See discussion supra at 6.

we find that these proposed activities are consistent with prior OCC opinions and the Subsidi..ies may engage in such activities.

The Bank proposes to acquire a subsidiary engaged in the business of investing and selling to its customers certain precious metals (i.e. gold, silver and platinum bullion, American gold eagle coins and Canadian maple leaf coins). National banks have express authority to buy and sell "coin and bullion" under 12 U.S.C. § 24(Seventh). The OCC has permitted national banks to buy and sell, as agent for customers and for the bank's own account, gold, silver, and platinum coins and bullion. See e.g., Interpretive Letter No. 553 (May 2, 1991), reprinted in [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,300; Interpretive Letter No. 390 (July 28, 1987), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,614; Interpretive Letter No. 326 (January 17, 1985), reprinted in [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,496.

Another proposed subsidiary will hold certain loans previously made in 1992 which are secured by shares of the Dreyfus Funds. As part of or incidental to the business of banking, national banks and their operating subsidiaries may make and hold loans. 12 U.S.C. § 24(Seventh); see also 12 C.F.R. § 7.7379. Because the Bank has represented that holding the loans that predated this acquisition is the only activity engaged in by this subsidiary, such activity is permissible regardless of the fact that the loans are secured by Dreyfus shares.[33] Another subsidiary will engage only in receiving payments under a Noncompetition Agreement and passing them to the parent Dreyfus Corporation. The subsidiary is a party to a Noncompetition Agreement with The Bank of New York (Delaware), which expires in 1995. This activity also is permissible as part of or incidental to the business of banking under 12 U.S.C. § 24(Seventh).

Lastly, Mellon Bank (DE) proposes to acquire a Dreyfus subsidiary that engages in the sale, as agent, of variable annuity products. This subsidiary will become a subsidiary of MBC Insurance Agency, located in Lewes, Delaware, a place of under 5000 inhabitants.[34] Based on this representation, the OCC's approval includes the sale, as agent, of insurance and annuities products. The subsidiary will engage in activities consistent with 12 U.S.C. § 92. The OCC previously has concluded and maintains that national banks and their operating subsidiaries may buy and sell annuities as agent for customers under authority granted by 12 U.S.C. § 24(Seventh). See e.g., Interpretive Letter No. 499 (February 12, 1990), reprinted in [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,090; Interpretive Letter No.

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[33] This subsidiary will not acquire other loans to hold in the future. In addition, one of the conditions of this approval is that the Bank will not accept shares of the Dreyfus Funds as collateral for loans used to purchase shares of the Dreyfus Funds. The Bank has represented that it will not make any loans for the purpose of purchasing shares of the Dreyfus Funds.

[34] MBC Insurance Agency, Inc. is a subsidiary of Mellon Bank (DE) which the OCC previously has approved to engage in general insurance agency activity.

428 (May 11, 1988), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,562; Interpretive Letter No. 331 (April 4, 1985), reprinted in [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,501.[35] This subsidiary should be particularly mindful of the requirements of the Interagency Statement that pertain to annuities sales.

Application of the Interagency Statement

The federal bank and thrift regulatory agencies issued a joint statement on retail sales of mutual funds and other nondeposit investment products by federally insured financial institutions on February 15, 1994. The Interagency Statement sets forth the uniform views of the bank regulatory agencies on standards for the safe and sound operation of banks. The Interagency Statement supersedes earlier guidance issued by the agencies and is applicable to both the Bank and the Subsidiaries.

The Interagency Statement sets forth specific guidelines which pertain to the sale of mutual fund shares, as well as to related advertising and promotional activities, and provides that banks should market such nondeposit products in a manner that is not misleading or confusing to customers as to the nature of the products and the risks. The Statement provides guidance on disclosures to customers, sales location, the suitability of particular investments for particular customers, compensation of sales personnel and other sales practices. In particular, where mutual funds are recommended or sold to retail customers, the Statement provides that customers be fully informed that the products are not insured by the FDIC; are not deposits or other obligations of the institution and are not guaranteed by the institution; and are subject to investment risks, including possible loss of the principal invested. The Interagency Statement does not proscribe the use of different language for these disclosures so long as the customer receives a disclosure conveying the same information.

The Interagency Statement applies to the Bank and the Subsidiaries when:

- sales or recommendations are made by employees of the Bank;
- sales or recommendations are made by employees of the Subsidiaries occurring on the Bank's premises, including telephone sales or recommendations and sales or recommendations initiated by mail; and

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[35] Although a recent decision in the Fifth Circuit found to the contrary, the OCC's position remains that national banks may sell annuities pursuant to authority found in 12 U.S.C. § 24(Seventh). See Variable Annuity Life Ins. Co. v. Clarke, 998 F.2d 1295 (5th Cir. 1993), reh'g denied, Variable Annuity Life Ins. Co. v. Ludwig, 13 F.3d 833 (5th Cir. January 13, 1994), petition for cert. filed, --U.S.L.W.-- (April 13, 1994).

- sales are made by employees of the Subsidiaries resulting from a referral of retail customers to the Subsidiaries by the Bank.

With respect to other sales activities, the Bank has represented that the Subsidiaries will provide the Interagency Statement disclosures in an acknowledgement that is contained in the application form, the prospectus, confirmations, periodic statements, supplemental (i.e. post-prospectus) sales literature, and brochures that contain promotional or sales material.[36] In any other customer contact involving a sales presentation, solicitation or investment recommendation or in any advertising, the Subsidiaries will comply with applicable SEC and NASD requirements and will also specifically disclose the lack of FDIC insurance.[37] See e.g., NASD Notice to Members 94-16 (March 1994); NASD Notice to Members 93-87 (December 1993).[38]

With regard to securities sales and recommendations. the OCC now interprets the Interagency Statement provision on suitability to adopt standards identical to the NASD's suitability rule. See Article III, Section 2 of the Rules of Fair Practice, NASD Manual. Accordingly, national banks and their operating subsidiaries have the same information gathering responsibility and suitability analysis requirement with respect to money market funds as imposed by the NASD's rule. The OCC expects national banks and their operating subsidiaries to comply fully with the Interagency Statement's guidelines. The OCC is willing to consider further requests for interpretation of the Interagency Statement as it applies to particular situations.

Please be advised that if compliance difficulties arise related to these activities (including any evidence that customers were unaware of or did not understand the relationships involved between the entities), the OCC may impose additional limitations on the Subsidiaries' activities.

Conclusion

The OCC approves the Bank's operating subsidiary notice on the condition that the Bank conducts the activities as proposed in the Notification and complies with the following supervisory conditions:

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[36] Further, the Bank represents that the Subsidiaries will provide the Interagency Statement disclosures in any advertisement by the Subsidiaries that makes a comparison to a bank deposit.

[37] We note that the Bank has represented that the Mellon name will not be linked in advertisements, solicitations or sales literature (except to the extent required to be mentioned in the prospectus) to the Dreyfus Funds.

[38] The NASD in Notice 93-87 directs all members to provide full and fair disclosure in all oral and written communications to customers, including in particular the risk to principal. See NASD Notice to Members 93-87 (December 1993).

(1) The Bank and the Subsidiaries will maintain an adequate level of equity capital. In assessing the appropriate level of capitalization, the Bank should include within its evaluation the various risks incurred, e.g., liquidity, fiduciary, operational, and legal. The Subsidiaries also will comply with applicable SEC capital requirements.

(2) The Bank and the Subsidiaries are deemed "affiliates" of the Dreyfus Funds for purposes of Sections 23A and 23B of the Federal Reserve Act and thus are subject to the restrictions on transactions between affiliates. See 12 U.S.C. § 371c and 371c-1.

(3) The Bank's aggregate direct and indirect investments in and advances to the Subsidiaries shall not exceed an amount equal to the Bank's legal lending limit.

(4) The Bank shall not accept shares of the Dreyfus Funds as collateral for a loan used to purchase shares of the Dreyfus Funds.

(5) The Bank and/or the Subsidiaries will not purchase shares of the Dreyfus Funds for its own account.

(6) The Bank will not purchase in its sole discretion in a fiduciary capacity shares of the Dreyfus Funds, unless expressly authorized by the instrument, court order or local law and consistent with 12 C.F.R. Part 9, state law, and general fiduciary obligations.

(7) The Bank and/or the Subsidiaries shall not extend credit to the Dreyfus Funds (except for extensions of credit made in the ordinary course of providing custodial or cash management services to the Funds).

(8) The Bank and the Subsidiaries are subject to the Interagency Statement (2/15/94) regarding sales of nondeposit investment products as described on pages 19-20 of this letter. With respect to other sales activities, the Subsidiaries will provide the disclosures as described on page 20 of this letter.

(9) The Bank and the Subsidiaries must comply with each of the voluntary commitments contained in the Bank's Policy Statement on Mutual Funds. A copy of the Policy Statement is attached.

(10) The Bank will submit an action plan acceptable to the OCC that sets forth the post merger management reporting structure and organization chart which specifically defines lines of authority, responsibility, and accountability for the Subsidiaries and establishes information systems to monitor and measure the impact of the transaction going forward.

(11) The Bank will submit an action plan acceptable to the OCC which specifies the scope and timing and details of how the holding company's audit and compliance function will oversee the audit and compliance functions at the Subsidiaries.

(12) The Bank must submit a notice to the OCC pursuant to 12 C.F.R. § 5.34, if the Subsidiaries at some future time decide to engage in new activities, i.e. activities not covered by the current notice and the OCC's response to the notice, including activating the subsidiaries being acquired that are currently inactive. This submission must be made even though the activities have been found to be permissible for national banks.

(13) The Bank and the Subsidiaries will comply fully with all applicable laws, regulations, orders and directives of regulatory bodies and with the rules of all self-regulatory bodies including the NASD.

Please be advised that the conditions of this approval are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818. This response is based solely on the facts as represented and any changes in the facts might require a different result. Our analysis also reflects current legal and prudential standards, and is subject to revision as future developments warrant.

Sincerely,

Frank Maguire

Frank Maguire
Senior Deputy Comptroller for
Corporate Activities and Policy Analysis

cc: H. Rodgin Cohen, Esq.

Attachment

POLICY STATEMENT ON MUTUAL FUNDS

I. Introduction

A. This Policy Statement provides guiding principles for (1) sales of shares of registered investment companies ("mutual funds") by Mellon Bank Corporation, its bank subsidiaries ("Mellon Banks") and its other subsidiaries (collectively, "Mellon Companies"); (2) relationships between Mellon Companies and mutual funds for which Mellon Companies provide advisory services ("Mellon-Advised Funds"); and (3) relationships between Mellon Banks and The Dreyfus Corporation ("Dreyfus") as a subsidiary of Mellon Bank, N.A., the principal Mellon Bank.

B. These guiding principles have the following objectives: (1) providing customers with disclosures of the benefits and risks of investing in mutual fund shares, and particularly ensuring that customers are clearly informed that such shares are not insured by the Federal Deposit Insurance Corporation ("FDIC") and are not bank obligations; (2) assessing the suitability of mutual funds that a Mellon Company recommends; (3) providing convenient and efficient financial services to customers; (4) ensuring the safety and soundness of both the Mellon Banks

and the Mellon-Advised Funds; (5) preventing conflicts of interest; (6) maintaining separation between Mellon Companies and Mellon-Advised Funds; and (7) maintaining separation between Mellon Banks and Dreyfus.

II. Customer Protections

A. No Mellon Company will sell shares of a mutual fund or advise a mutual fund if such fund has a name, title or logo that is the same as the name, title or logo of a Mellon Bank or is so similar to such a name, title or logo as to be confusing to customers.

B. No employee of any Mellon Company will state or imply that a mutual fund or the shares of a mutual fund are guaranteed or insured by the United States Government or any of its agencies, including without limitation the FDIC, or that the fund or fund shares are an obligation of a bank.

C. The disclosures set forth in II.D. below will be made conspicuously in writing to any customer who purchases shares of a mutual fund at a Mellon Bank branch office or who opens an investment or similar account with a Mellon Company at a Mellon Bank branch office through which he or she can make such purchases.

D. The following disclosures will be made to customers specified in II.C. above:

1. That the shares are not insured by and are not an obligation of the FDIC or any other government agency;

2. That the shares are not a deposit or obligation of and are not endorsed or guaranteed by any Mellon Bank or any other bank;

3. That the investment poses investment risks, including the possible loss of principal, and that the investment may fluctuate in value so that when the investment is sold by the customer it may be worth more or less than when purchased by the customer;

4. To the extent applicable, that there exists an investment adviser relationship between a Mellon Company and the mutual fund, and a statement that Mellon Companies may have other types of relationships (such as custodian or transfer agent) with the mutual fund; and

5. That, if applicable, there are deferred sales charges to which the shares may be subject.

E. The disclosures required in II.D. above will be made on or before the earlier of (1) the initial purchase of the investment to which they relate or (2) the opening of the initial account through which such purchases can be made. These disclosures will appear on a separate sheet of paper or in a prominent location in the other papers signed by the customer to make an initial purchase of the shares or to open the account. At the time that these disclosures are made, the Mellon Company making the disclosures will obtain a statement, signed and dated by the customer, that contains a declaration that the customer has read and understood the disclosures provided by the Mellon Company with respect to that investment or account.

F. The disclosures required in paragraph II.D. will appear conspicuously in any written advertisement, solicitation, or promotional or other sales material for a specific mutual fund if the material also mentions a Mellon Bank or is specifically directed to Mellon Bank customers.

G. In connection with any investment in a mutual fund, any confirmation notice or periodic statement issued by a Mellon Company or by a transfer agent for any Mellon-Advised Fund will disclose that the investment is not FDIC-insured and is not an obligation of or guaranteed by any bank.

H. Each Mellon Bank will post, in a conspicuous place in that part of any branch banking office in which any shares of mutual funds are sold, a notice that those shares are not insured by the FDIC.

I. No sales of shares of a mutual fund will be made and no recommendations concerning such mutual fund shares will be provided at a teller's window in a Mellon Bank.

J. Mellon Company employees recommending and selling mutual funds ("Investment Services Employees") will be properly qualified and trained. Their training will include product knowledge, customer protection and compliance with all applicable laws, regulations and self-regulatory standards. No person will recommend or sell mutual fund shares in Mellon Bank branches unless he or she is registered with the National Association of Securities Dealers ("NASD") as a broker or dealer, or as a representative of a broker or dealer, or as an investment adviser. All employees who in the regular course of their employment refer customers to persons authorized to recommend or sell mutual fund shares will receive product and compliance training appropriate to and clearly defining their limited and specific roles in making those referrals.

K. Background inquiries about new Investment Services Employees with previous securities industry experience will include a check of disciplinary history with securities regulators.

L. Each Investment Services Employee will attempt in good faith to determine whether an investment in a mutual fund is suitable for a customer or potential customer before recommending such security for the customer, to the full extent required by NASD Rules of Fair Practice. Suitability inquiries will be made of the customer and responses documented, consistent with the NASD Rules of Fair Practice, concerning the customer's financial status, tax status, investment objectives, risk tolerance, and other factors that may be relevant, prior to making recommendations to the customer.

M. Mellon Company compensation programs will be administered and monitored to guard against a recommendation by an Investment Services Employee of an unsuitable Mellon-Advised Fund to any customer.

N. Tellers at Mellon Banks will not receive referral fees based on the success of sales of shares of mutual funds.

O. No Mellon Bank will share confidential customer information with any Mellon Company providing investment services other than (1) information which the bank's customer has consented to share with third parties or (2) information of a type that the Mellon Company could receive in a credit bureau or other third party report on the customer.

III. Independence of Funds' Boards

A. Mellon-Advised Funds will have boards of directors that are independent of the Mellon Companies.

B. Specifically, no director, officer or employee of a Mellon Company will serve as a director of any Mellon-Advised Fund.

C. No Mellon Company will advise any mutual fund that does not have a majority of independent directors. An independent director will not include any person who is an "interested person" with respect to such fund as defined in Section 2(a)(19)(A) of the Investment Company Act of 1940 (the "1940 Act") or as defined in any future amendment to the 1940 Act or the rules, regulations, directives or orders thereunder.

D. No Mellon Company will advise any mutual fund if a majority of the mutual fund's directors are officers, directors or employees of any bank holding company or its affiliates and subsidiaries or any bank or its subsidiaries.

IV. Independence of Funds

A. No director, officer or employee of a Mellon Company will be a director, officer or employee of a Mellon-Advised Fund.

B. No Mellon Company will control a Mellon-Advised Fund.

C. In the event that Mellon Bank Corporation and its subsidiaries possess the power to vote more than 25% of the shares of a Mellon-Advised Fund, whether in a fiduciary capacity or otherwise, Mellon Bank Corporation and its subsidiaries (1) with respect to any such shares owned by any of them for its own account, will vote such shares in the same proportion as shares held by all other shareholders of such mutual fund and (2) with respect to any such shares owned by any of them in a fiduciary capacity with voting power, to the extent consistent with its fiduciary duties and applicable law (including ERISA), will either (a) pass through the power to vote to the beneficial owners of such shares or (b) vote such shares as provided in clause (1).

V. <u>Relationships between Mellon-Advised Funds and Mellon Bank Corporation</u>

A. No Mellon Company will make a loan or extend credit to a Mellon-Advised Fund, except for loans or extensions of credit made in the ordinary course of providing custodial or cash management services to such a fund.

B. In the event that the assets of a Mellon-Advised Fund are held in custody by a Mellon Bank, the applicable Mellon Company will recommend

to the board of directors of such fund that a firm of nationally recognized independent public accountants issue reports in accordance with Rule 17f-2 under the 1940 Act and otherwise as required by law with respect to the custody of the assets of such fund.

C. No Mellon Company will purchase any portfolio securities for its own account from, or sell any portfolio securities from its own account to, a Mellon-Advised Fund.

D. If a Mellon Company is underwriting or placing any security, it will not sell such security to a Mellon-Advised Fund.

.E. Mellon Companies and their affiliates will be 'affiliated persons' of the Dreyfus Funds to the extent required under the 1940 Act.

VI. Relationships Between Mellon Banks and Dreyfus

All transactions between Mellon Banks and Dreyfus and its subsidiaries will be subject to Sections 23A and 23B of the Federal Reserve Act without giving effect to the exemption set forth in subsection (b)(2)(A) of Section 23A.

VII. Conflicts of Interest

A. No Mellon Company advising a Mellon-Advised Fund will recommend the purchase by a Mellon-Advised Fund (other than an index or similar passively-managed fund) of securities in the process of issuance if an employee in any such Mellon Company has actual knowledge that the proceeds of an issuance of securities will be used to retire indebtedness to a Mellon Company.

B. No Mellon Company will purchase for any third party account over which the Mellon Company has discretionary authority a security issued by a Mellon-Advised Fund, except as authorized by the instrument creating the relationship, by the beneficiaries of such account, by court order or by applicable local law.

C. In the event that shares of a Mellon-Advised Fund are purchased for a Mellon Bank fiduciary account with respect to which a Mellon Company has investment discretion, an appropriate Mellon Bank employee will conduct a review, at least once during every calendar year, of the continuing prudence of holding such shares.

D. No Mellon Bank will make a loan for the purpose of purchasing shares of a Mellon-Advised Fund.

VIII. Regulation

A. The Mellon Companies will comply in full with all applicable laws, regulations, orders and directives of regulatory bodies and with the rules of all self-regulatory bodies including the NASD. This Policy Statement will not be interpreted to prohibit or limit any activity which is required under applicable law, regulation, order or directive issued from time to time by the SEC or its staff or which is taken in response to a recommendation or endorsement received from the SEC or its staff by way of no-action or interpretive relief or otherwise.

B. For so long as any Mellon Company is defined as a "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 (the "1934 Act"), such company will continue to be maintained as a separate company, registered with the SEC and subject to the 1934 Act. In addition, for so long as any Mellon Company is defined as an "investment adviser" under the Investment Advisers Act of 1940 (the "Advisers Act"), such company will continue to be maintained as a separate company, registered with the SEC and subject to the Advisers Act.

C. Dreyfus will be maintained as a separate corporate entity and its present registered broker-dealer subsidiary, Dreyfus Service Corporation, will remain registered as a broker-dealer with the Securities and Exchange Commission.

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IX. <u>Compliance and Control</u>

A. Sales of and recommendations to purchase mutual fund shares will meet or exceed all applicable legal, regulatory and self-regulatory standards including, where applicable, the NASD Rules of Fair Practice. Applicable areas of the Mellon Companies will incorporate structures, procedures and mechanisms designed to ensure compliance with these standards and the Mellon Companies' own rules. The compliance functions in the Mellon Companies will be performed independently of investment product sales and management.

B. The Mellon Companies will utilize compliance procedures with respect to suitability determinations such as requiring recorded documentation by all representatives making recommendations on mutual funds, requiring a senior representative to sign off on such documentation and requiring that specially designated compliance officers sample such documentation on a periodic basis.

C. The Mellon Companies will utilize compliance procedures which include a system to monitor customer complaints.

D. Mellon Company employees with responsibility for the review of sales of shares of mutual funds and compliance with this Policy Statement will receive dedicated training designed to ensure their ability to

perform their functions consistently with this Policy Statement and its objectives.

E. The Board of Directors of Mellon Bank Corporation will oversee Mellon's investment services and will adopt and review policies to ensure that these activities are carried out in compliance with all applicable laws and regulations and with this Policy Statement. The Board of Directors of Mellon Bank Corporation will formally approve this Policy Statement, and no material changes in this Policy Statement will be made without the approval of such board.

WPPDOCGG - 13154
04/21/94

Congress of the United States
House of Representatives
Washington, DC 20515

December 20, 1993

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight, respectively, of banks and banking, including deposit insurance, and of securities and exchanges, we are looking into the facts and circumstances surrounding the proposed merger between Mellon Bank Corporation and The Dreyfus Corporation, particularly the significant legal, regulatory, and public policy issues that are raised thereby (see enclosed correspondence).

In order to assist us in this matter, we respectfully request that your agency provide us by the close of business on Friday, January 7, 1994, an analysis of the issues that the proposed transaction and resultant structure raise under the federal securities laws. At a minimum, your analysis should include the following:

1. Analysis of the potential conflicts of interests that may be raised in connection with the distribution and sale of investment company shares and the management of investment companies by The Dreyfus Corporation after its merger with Mellon Bank Corporation.

2. Analysis of the potential conflicts of interest that may arise between the investment company and the investment advisory functions of The Dreyfus Corporation and the banking functions of Mellon Bank Corporation after completion of the proposed merger.

The Honorable Arthur Levitt, Jr.
Page 2

3. Assuming different scenarios as to the manner of operation of The Dreyfus Corporation by Mellon Bank Corporation after consummation of the proposed merger, any limitations that may be imposed thereby on the ability of the Securities and Exchange Commission to discharge adequately its functions of examination and review to ensure compliance with the federal securities laws administered by it.

4. The question whether, as a result of or in conjunction with the proposed merger, additional legislation is needed or desirable to ensure the ability of the Securities and Exchange Commission to discharge its regulatory functions or otherwise to provide protection for investors in mutual funds offered by or through The Dreyfus Corporation or Mellon Bank Corporation.

Thank you for your cooperation and attention to our request.

Sincerely,

Henry B. Gonzalez
Chairman
Committee on Banking, Finance and Urban Affairs

John D. Dingell
Chairman
Committee on Energy and Commerce

Rec'd 1-10-94
9:50AM

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

January 7, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Henry B. Gonzalez
Chairman
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Dingell and Chairman Gonzalez:

In your letter to us dated December 20, 1993, you asked for our analysis of a number of legal issues arising under the federal securities laws in connection with the proposed merger of Mellon Bank Corporation and the Dreyfus Corporation. In response to your request, I asked the Commission's Division of Investment Management and the Office of General Counsel to prepare the enclosed memorandum.

The Mellon/Dreyfus merger underscores the need for legislation that would provide for the functional regulation of securities activities. We believe that all financial institutions that engage in securities activities should be required to comply with the federal securities laws and regulations, and we therefore strongly support legislation sponsored by Chairmen Dingell and Markey and Congressmen Moorhead and Fields, H.R. 3447.

We share the concerns you both have raised recently regarding investor confusion about mutual funds advised or sold by banks and their affiliates, and we commend Chairman Gonzalez for calling attention to this issue in H.R. 3306. We believe that the potential for that type of confusion on the part of Mellon and Dreyfus customers after completion of the proposed merger will be great in the absence of protective measures taken by both Mellon and Dreyfus. We will continue to work closely with our banking regulator counterparts to ensure that Mellon and Dreyfus take steps to address our concerns.

I hope this memorandum satisfactorily responds to the questions you raised about the merger. If you have any further questions regarding the issues raised in your letter, please contact me, Barry Barbash, Director of the Division of Investment Management, or Simon Lorne, General Counsel.

Sincerely,

Arthur Levitt
Chairman

Enclosure

MEMORANDUM

January 7, 1994

To: Chairman Levitt

From: Division of Investment Management
Office of General Counsel

Subject: Letter from Congressmen Dingell and Gonzalez re: Merger of Dreyfus and Mellon

This memorandum responds to Chairmen Dingell and Gonzalez's December 20, 1993 letter in which they ask several questions regarding the proposed merger between Dreyfus Corporation ("Dreyfus") and Mellon Bank Corporation ("Mellon"). Chairmen Dingell and Gonzalez asked that we analyze relevant federal securities law issues relating to the proposed merger. Our responses correspond to the respective questions.

We understand that the Mellon/Dreyfus merger is intended to be so constructed as to minimize the concerns we raise in this memorandum. However, we are troubled that there are insufficient legal safeguards of the type we consider important, and that other entities, faced with different circumstances, may behave less responsibly.

I. Background

On December 6, 1993, Mellon and Dreyfus announced their agreement to merge in a transaction valued at $1.85 billion.1/ The staff understands that Dreyfus will become a subsidiary of Mellon Bank.

Dreyfus is a registered investment adviser that advises, among other things, the sixth largest family of mutual funds in the United States. Mellon is the 21st largest bank holding company in the United States (according to asset size) and is the parent of Mellon Bank. Mellon Bank is the investment adviser to one family of funds, the Laurel Funds, with $3.3 billion in assets.2/ Mellon Bank currently ranks 22nd among banks in mutual fund assets under management. Mellon also purchased Boston Group Holdings in 1993. Boston Group Holdings is the parent of Boston

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1/ *See* MELLON BANK & DREYFUS, *Mellon Bank Corporation and the Dreyfus Corporation to Merge in Stock Transaction Valued at $1.85 Billion,* Dec. 6, 1993 (the "Press Release").

2/ *See* Lipper Analytical Services, LIPPER DIRECTORS' ANALYTICAL DATA (4th Ed., 1993) ("Lipper"). All asset figures are as of September 30, 1993.

Company Advisers, which administers 147 mutual funds with $60.5 billion in assets managed by independent advisers; it also advises the Boston Company funds with $1.3 billion in assets under management.3/ Dreyfus advises mutual funds with $72.2 billion in assets.4/ After the merger is completed and Mellon Bank assumes responsibility for managing the Boston Company funds, Mellon Bank and its affiliates, including Dreyfus, will be the largest bank mutual fund investment adviser, with $76.8 billion in mutual fund assets under management, or four percent of all mutual fund assets.5/ Mellon estimates that, after the merger, over 50% of its revenues will be from fees for financial services, including mutual fund advisory fees.6/

The Mellon/Dreyfus merger is one of the most dramatic examples of the recent growth of bank involvement in the mutual fund industry. Currently 113 banks or bank subsidiaries advise 943 mutual funds.7/ Bank mutual funds have $204 billion in assets, an increase of 29% since December 31, 1992.8/ Mutual funds overall have grown about 19% since December 31, 1992, to $1.9 trillion.9/ Banks also are increasingly active in selling mutual fund shares to the public.

II. Analysis

The Mellon/Dreyfus merger, as we understand it from the facts currently available, raises in a more highly visible context the concerns that we have previously expressed with respect to banks' involvement with mutual funds generally. These

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3/ *See id.* The Boston Company's preliminary proxy statement, filed with the Commission on December 17, 1993, indicates that Mellon intends to integrate the Boston Company funds and the Laurel Funds into a single fund complex with Mellon Bank as the investment adviser. Boston Advisers, a subsidiary of Mellon Bank, currently advises the Boston Company funds.

4/ *See id.*

5/ Currently, Provident National Bank is the largest bank mutual fund investment adviser, managing $19.9 billion in mutual fund assets. *See id.*

6/ *See* Press Release.

7/ *See* Lipper Analytical Services, LIPPER BANK RELATED FUND ANALYSIS (2d ed., 1993).

8/ *See id.*

9/ *See* Lipper, *supra* note 2.

concerns include the risk of investor confusion, certain conflicts of interest, and the need for particular and focused disclosure. It also, in our view, makes even more apparent the desirability of functional regulation, and of legislation to redress all of these concerns definitively.

A. Distribution and Sales Activities

Shares of the Dreyfus funds currently are distributed by Dreyfus Service Corporation, a wholly owned subsidiary of Dreyfus. The staff understands that, to satisfy the requirements of the Glass-Steagall Act, shares of the Dreyfus funds will be distributed by an unaffiliated entity after the completion of the merger.10/ The staff, therefore, does not anticipate that the distribution of Dreyfus funds' shares will present a conflict of interest.

It is currently unclear to what extent shares of Dreyfus funds will be sold through Mellon Bank to banking customers and whether such sales will be made by bank employees or by employees of a registered broker-dealer. Sales of mutual fund shares through a bank, particularly sales that take place in a bank's lobby, may confuse investors as to the uninsured nature of the funds.11/ Chairman Levitt expressed concern about the risk of investor confusion in testimony on November 10, 1993 before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee.12/ The ills that can result from such

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10/ The merger would, as a result of the Investment Company Act of 1940 ("Investment Company Act"), cause the automatic termination of each Dreyfus fund's contract with its principal underwriter and will require each fund's board of directors to approve a new contract with a principal underwriter.

11/ The Commission recently conducted a preliminary consumer survey that found that investors are confused as to the uninsured nature of bank sold mutual funds. The Commission plans to conduct further surveys to ascertain the extent of investor confusion.

12/ The Commission's staff expressed its concern about the risk of customer confusion last May when it required any mutual fund whose shares are sold by or through a bank to disclose prominently, on the cover page of its prospectus, that shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank, and that the shares are not federally insured by the Federal Deposit Insurance Corporation or any other agency. *See* Letter from Barbara J. Green, Deputy Director, Division of Investment Management, to Registrants (May 13, 1993).

confusion were demonstrated recently by the massive fraud that took place in connection with the sale of American Continental Corporation's debt securities in Lincoln Savings' branches.

B. Conflicts of Interest Between Investment Adviser and Bank

The merger creates potential conflicts of interest between Mellon Bank and the Dreyfus funds which it appears they are attempting to address.13/ To address conflicts of interest of this sort more generally, the Commission has supported legislation that would amend the Investment Company Act to (1) prohibit an investment company from borrowing from an affiliated bank, except as permitted by the SEC; (2) prohibit an investment company from purchasing securities in an underwriting, the proceeds of which are used to retire debt owed by the issuer to a bank that advises the investment company, except as permitted by the SEC; (3) prohibit an investment company from using an affiliated bank as a custodian, except as permitted by the SEC;14/ (4) prevent an investment company's investment adviser that also acts as trustee for trust clients from perpetuating itself as the investment adviser even where that continued relationship is not be in the shareholders' best interest; (5) prevent an investment company's investment adviser from using the investment company to support the advisers' other business clients by causing the investment company to purchase securities or other property from those clients; and (6) strengthen the

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13/ In a meeting on December 22, 1993, between the Commission's staff and Daniel C. MacLean, Vice President and General Counsel of Dreyfus, Mr. MacLean stated that Mellon Bank handles conflicts of interest between its trust department and its lending operations by maintaining a "Chinese Wall" to restrict the flow of information between those operations. Mr. MacLean stated that Mellon is contemplating erecting a Chinese Wall between Mellon Bank and Dreyfus to mitigate some of the potential conflicts of interest between their banking and mutual fund operations.

14/ The Dreyfus funds currently maintain custody of their assets with the Bank of New York. In the December 22, 1993 meeting, Mr. MacLean represented that the boards of directors of the Dreyfus funds probably would make Mellon Bank the funds' custodian. One analyst has stated that Mellon Bank could increase its revenues by $40 million per year by acting as custodian for the Dreyfus funds. *See Mellon/Dreyfus: The Lion that Squeaked*, THE ECONOMIST, Dec. 11, 1993, at 86.

independence of investment company boards of directors.15/ For the most part, such legislative amendments are designed to preclude the kinds of abuses that existed historically and were the basis for Glass-Steagall prohibitions.

C. Commission Oversight of Dreyfus

As a registered investment adviser, Dreyfus is subject to Commission regulation, examination, and oversight. Banks are excluded from the definition of "investment adviser" under the Investment Advisers Act of 1940 ("Advisers Act"). As a result, banks that advise mutual funds are not required to register as investment advisers, to comply with the Advisers Act and the rules thereunder, or to submit to Commission examination.16/

The staff has been advised that the parties to the merger intend that Dreyfus will remain a registered investment adviser fully subject to the Commission's regulatory, examination, and oversight authority.17/ However, if Mellon Bank at some later time decides to assume the role of investment adviser to the Dreyfus funds, as it apparently will do in the case of the Boston Company funds, the Commission could not preclude Mellon Bank from doing so and therefore Mellon Bank's advisory activities would be outside the Commission's jurisdiction. This would be detrimental to the Commission's ability to examine the Dreyfus funds and to enforce their compliance with the federal securities laws. It would be more difficult for the Commission's examiners to understand fully the funds' operations, and they could be

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15/ Because Mellon Bank is a member bank, Section 32 of the Glass-Steagall Act, 12 U.S.C. § 78, would prohibit any officer, director, or employee of Mellon Bank or its holding company from being a director of a Dreyfus fund.

16/ Bank holding companies are also excluded from the Advisers Act. If Mellon (the holding company), rather than Mellon Bank, had acquired Dreyfus, Mellon would not have been required to register.

17/ Mr. MacLean assured the Commission's staff, in the December 22, 1993 meeting, that Dreyfus would become a subsidiary of Mellon Bank and that the Dreyfus funds would continue to be advised by a registered investment adviser. Dreyfus has filed a "sticker" to its funds' prospectuses disclosing Dreyfus' agreement to merge with Mellon, and stating that Dreyfus will be a separate subsidiary within the Mellon organization.

hindered in their ability to detect violations of the federal securities laws.18/

D. Need for Additional Legislation

The Mellon/Dreyfus merger underscores the need for functional regulation of bank securities activities. The Commission currently regulates all mutual funds under the Investment Company Act, including bank advised funds. Due to statutory provisions that exclude banks from regulatory requirements that apply to investment advisers and broker-dealers, however, the Commission has only limited ability to regulate the banks that advise and/or sell interests in such mutual funds. The Commission believes that these bank exclusions should be eliminated in light of the dramatic increase in bank securities activities over the past decade, and especially since banks are among the largest participants in the securities business (as illustrated by the Mellon/Dreyfus merger).

As previously noted, because banks are excluded from the Act's definition of "investment adviser," Commission examiners cannot comprehensively view a bank advised mutual fund's operations because the adviser's records are not available for inspection.19/ This creates a particularly significant gap with respect to the evaluation of potential conflicts of interest between a mutual fund and its adviser.20/ As discussed above in

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18/ Regardless of how the merger occurs, it will cause an "assignment" of Dreyfus' investment advisory contracts with the Dreyfus funds. The Investment Company Act requires that any investment advisory contract with a registered investment company contain a provision to the effect that an assignment automatically terminates the contract, and that both the fund's directors and shareholders approve a new advisory contract. Dreyfus' recently filed prospectus sticker discloses to fund shareholders that the advisory contracts will be terminated and that Dreyfus intends to obtain board and shareholder approval of a new advisory contract.

19/ Bank fiduciary activities are inspected by the federal banking regulators. These inspections, however, do not focus on issues such as conflicts of interest under the Investment Company Act -- nor are they coordinated with Commission inspection and enforcement efforts, which focus on securities law issues.

20/ As noted above, the staff has been advised that Dreyfus will remain a registered investment adviser. The Mellon/Dreyfus merger, thus, does not appear to pose these problems (continued...)

Part II.B., banks that advise mutual funds also face certain conflicts of interest that the Investment Company Act does not explicitly address.

Because banks are excluded from the Securities Exchange Act of 1934, they are not regulated as broker-dealers.21/ Instead, banks that engage directly in securities activities are governed by a federal bank regulatory system that focuses generally on bank safety and soundness issues. While the federal banking regulators have adopted certain recordkeeping and confirmation requirements for securities transactions,22/ they do not have a comprehensive regulatory scheme for the securities activities of banks.23/ Banks do not have to register or satisfy specific capital requirements in order to engage in direct securities activities, and the banking regulations contain no provisions comparable to the federal securities law rules respecting securities training and qualification, suitability, and other sales practice issues.24/

20/(...continued) directly, although Mellon Bank's acquisition of the Boston Company funds' investment adviser does.

21/ Banks at the present time may engage directly in securities activities through their own employees, and/or indirectly through contractual arrangements with registered broker-dealers, pursuant to which registered representatives offer and sell securities in association with the bank. The concerns raised here pertain to direct bank securities activities. Unfortunately, because banking regulators do not receive formal notice or registration when banks commence securities activities, it is hard to estimate how many banks currently engage directly in such activities.

22/ *See, e.g.*, 12 C.F.R. §§ 12.1-12.7; 208.8(k); and 344.1-344.7.

23/ Although banks are excluded from broker-dealer regulation, banks (and bank sales of securities) are subject to the antifraud provisions of the federal securities laws and to Commission enforcement of such laws. Moreover, bank affiliates and subsidiaries are not excluded from broker-dealer regulation, and must register with the Commission if they engage in broker-dealer activities.

24/ These issues were discussed previously in a Memorandum of the Securities and Exchange Commission to the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning Financial Services Deregulation and Repeal of the Glass-Steagall Act (April 11, 1988).

In recent months, the federal banking regulators have adopted guidelines applicable to bank sales of mutual funds and other nondeposit investment products.25/ These efforts are an important first step. However, four separate sets of banking guidelines are no substitute for the uniform, comprehensive scheme provided for broker-dealer regulation under the federal securities laws. Investors are entitled to a single, consistent standard of protection, whether they purchase securities from a national bank, a state member or nonmember bank, a thrift, or a registered broker-dealer. Nor are the guidelines comparable in content to the federal securities laws. For example, the OCC's guidelines charge each bank with developing its own testing and qualification programs -- which means that there will be no uniform testing and qualification standards for bank personnel engaged in sales of securities. An additional difference with critical significance for investor protection is that the banking guidelines, unlike requirements under the federal securities laws, are not legally enforceable by the banking regulators or by customers.26/

25/ *See* Office of the Comptroller of the Currency ("OCC") Banking Circular No. 274 (July 19, 1993); letter from Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, on "Separation of Mutual Fund Sales Activities from Insured Deposit-Taking Activities" (June 17, 1993); Federal Deposit Insurance Corporation Supervisory Statement on State Nonmember Bank Sales of Mutual Funds and Annuities (Oct. 8, 1993); Office of Thrift Supervision Bulletin 23-1, "Guidance on the Sale of Uninsured Products" (Sept. 7, 1993). The National Credit Union Association currently is preparing guidelines for credit union sales of mutual fund shares to customers. *See* James B. Arndorfer, *Regulator Setting Guidelines for Mutual Fund Disclosure*, AMERICAN BANKER, Dec. 10, 1993, at 9.

26/ The guidelines are also troubling from a functional regulation viewpoint. In particular, the OCC's Banking Circular No. 274 suggests that the OCC may apply its guidelines (which are not identical to Commission and securities self-regulatory organization rules, and appear in some instances actually to conflict with those rules) to registered broker-dealers that sell securities on bank premises or have other contractual arrangements with banks. The OCC further suggests that its examiners may examine such registered broker-dealers for compliance with its guidelines as well as for compliance with federal securities laws and requirements. Since registered broker-dealers are already subject to Commission and self-regulatory organization

(continued...)

Thus, the new bank guidelines do not close the gulf that has long existed between federal securities regulation and the bank regulatory scheme for bank securities activities. Indeed, this gulf, recognized as early as 1977 in the Commission's Congressionally-mandated Report on Bank Securities Activities,27/ continues to grow. In the past two decades, expansive administrative interpretations of the Glass-Steagall Act have allowed ever-increasing bank involvement in mutual fund and other securities activities. The Mellon/Dreyfus merger is the latest illustration of this trend. The size of the proposed merger demonstrates that the need for consistent and comprehensive regulation of bank securities activities is more pressing than ever.

As discussed above in Part II.A., the Mellon/Dreyfus merger highlights the potential for increased customer confusion when banks sell mutual fund shares to their retail customers. Recent surveys indicate that a large number of investors misunderstand the risks involved with bank mutual fund investments -- specifically, the fact that federal deposit insurance does not cover bank sold or bank advised mutual funds.28/

A number of pending bills address the problem of customer confusion and other issues arising from bank sales of securities and mutual funds. One bill recently introduced by Chairman Gonzalez and Congressman Schumer (H.R. 3306, the "Depository Institution Retail Investment Sales and Disclosure Act") would require the federal banking agencies to adopt sales practice and disclosure rules governing bank sales of mutual funds and other non-deposit investment products. H.R. 3306 would take some positive steps toward reducing customer confusion about the

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26/(...continued)
oversight and regulation under the federal securities laws, OCC examinations would likely duplicate or confuse existing efforts.

27/ *See* Report on Bank Securities Activities of the Securities and Exchange Commission Pursuant to Section 11A(e) of the Securities Exchange Act of 1934 (Pub. Law 94-29), August 1977.

28/ News reports also suggest that banks are not consistently making disclosures that meet the bank regulators' guidelines. *See* Steven Lipin, *U.S. Warns Banks on Failure to Comply With Guidelines in Selling Mutual Funds,* WALL STREET JOURNAL, Nov. 8, 1993, at A16; *see also* Karen Holliday, Michael O'D. Moore, and Karen Talley, *Spot Check Finds Failures to Warn About Fund Risks,* AMERICAN BANKER, Nov. 19, 1993, at 1.

nature of bank sold nondeposit investment products. For example, the bill would prohibit common or similar names for banks and their investment company affiliates or nondeposit investment products.

It is troubling, however, that H.R. 3306 would discard a long-tested, successful securities regulatory framework, creating in its place a new regulatory scheme for bank securities activities, outside of and apart from the federal securities laws.29/ The bill would apply this scheme, moreover, not only to the direct activities of bank employees, but also to sales made by "any person" on behalf of a bank. This means that the new banking regulations adopted under H.R. 3306 could potentially apply to registered broker-dealers that have networking, leasing, or customer referral arrangements with banks, and perhaps even to those registered broker-dealers that provide clearing services to banks. The result would be duplicative or even conflicting regulation of registered broker-dealers.

By contrast, the approach taken in the bill introduced by Chairmen Dingell and Markey (H.R. 3447, the "Securities Regulatory Equality Act") builds on the proven regulatory structure created under the federal securities laws. Although the bill would maintain a limited exclusion for certain unsolicited bank securities activities, it would generally require bank securities activities (including mutual fund sales) to be moved into separate corporate entities subject to the federal regulatory scheme for brokers and dealers. Outmoded exemptions for bank advisory activities and pooled investment vehicles would also be eliminated from the federal securities laws. This legislation would significantly improve the existing regulatory system and enhance investor protection.30/ H.R. 3447 would serve investors by applying proven, legally enforceable

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29/ The laws enacted to govern bank municipal and government securities activities, by contrast, are grounded in the federal securities law concepts of market integrity and investor protection, and were appropriately incorporated into the federal securities laws rather than the federal banking laws.

30/ H.R. 3447 is virtually identical to legislation the Commission supported in 1991. It also closely resembles the Bank Broker-Dealer Act (S. 1175 and H.R. 2557), advocated by the Commission in 1987. H.R. 3447 would provide for functional regulation in place of the existing regulatory "crazy quilt" (under which the banking agencies regulate direct bank securities activities, while the Commission regulates securities subsidiaries and affiliates as well as bank holding companies, and enforces the federal anti-fraud provisions with respect to all market participants).

broker-dealer competency standards, supervision requirements, suitability and sales practice rules, and financial responsibility requirements to banks and bank employees involved in securities sales. The legislation would address the conflicts of interest between banks and their affiliated investment companies described in Part II.B. In general, by eliminating the unconditional bank exclusions in the federal securities laws, H.R. 3447 would promote consistent, functional regulation of all market participants that offer the same products and perform the same functions.

The Mellon/Dreyfus merger provides fresh proof that legislation addressing bank securities activities could enhance investor protections and rationalize federal securities regulation. H.R. 3447, in particular, would bring significant improvement to the regulation of bank securities activities by regulating all participants in our securities markets according to the functions they perform, rather than according to their industry classifications. However, the Commission and the federal banking regulators can take steps to improve the regulation of bank securities activities while awaiting legislative action. In particular, joint inspection programs and enhanced information sharing between the federal banking regulators and the Commission would allow for coordinated monitoring and responses to developing problems.

An important step toward better cooperation and coordination between the Commission and the federal banking regulators has been taken in recent weeks with the commencement of a joint effort to assess investor attitudes regarding mutual funds advised or distributed by banks. Following a preliminary survey of mutual fund investors conducted on behalf of the SEC in November of last year that suggested significant confusion about bank mutual funds, SEC staff, at the direction of Chairman Levitt, contacted the staff of the Office of the Comptroller of the Currency ("OCC") to initiate a broader, more comprehensive research project that would be conducted as a joint effort. This project is currently underway. Its results will be available in the near future and are expected to assist in developing the appropriate regulatory and/or legislative steps that may be warranted to address this specific issue.

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 226-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

February 23, 1994

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

As a starting point, we have reviewed the copy of the Notice of the transaction and supporting documentation that was delivered by MBC to the Committee on Energy and Commerce on January 3, 1994, as well as the responses of MBC and Dreyfus, the Securities and Exchange Commission (SEC), and the Comptroller of the Currency (OCC), responding to the December 10, 1993 Gonzalez-Dingell letter, and the response of MBC and Dreyfus to this Subcommittee's January 28, 1994 letter. In order to assist the Subcommittee in its investigation and in preparation for upcoming hearings, your cooperation is requested in providing the following information and responses by the close of business on Tuesday, March 1, 1994.

1. The Subcommittee asked MBC, Mellon Bank, and Dreyfus whether they had any enforcement actions filed against them during the past 10 years, and whether these entities had entered into any agreements with their respective regulators concerning compliance-related matters. A copy of the index to their response is enclosed. Please review it and advise the Subcommittee of any material omissions with respect to matters under your agency's jurisdiction. Also please advise us of any patterns involving compliance problems or violations about which we should be aware.

The Honorable Arthur Levitt, Jr.
Page 2

2. In December, Heine Securities Corporation (HSC) filed a Schedule 13D with the SEC in connection with the purchase of the common stock, par value $0.10 per share of the Dreyfus Corporation. HSC's response to Item 4 thereof states that: "Based upon HSC's review of the available public information concerning the Issuer, the prospective acquiror, the terms of the proposed merger and the process leading to the proposed merger, HSC is not convinced that the merger consideration fully reflects the underlying value of the Issuer." Please provide us with copies of any information or analyses in your possession that raise questions about the impact of this transaction on the shareholders of Dreyfus or otherwise indicates that the transaction might not be in their best interests. If such information or analyses are not currently in your possession, please take such steps as may be necessary to obtain any such material from the parties of the Mellon-Dreyfus transaction.

3. Last month, several shareholders in mutual funds marketed as part of the Dreyfus Funds filed an application with your agency pursuant to 17 CFR 270.0-5 for an order by the Commission that the "independent" directors of the Dreyfus Family of Funds are in fact "interested persons" under the Act. As we understand it, the crux of their complaint is that these directors have a disqualifying entanglement because their directorship of (and compensation by) other funds constitutes a prohibited material business relationship with other investment companies having the same investment adviser. Therefore, the application states that "Applicants and the other Dreyfus Fund shareholders have not and will not receive sufficient representation and protection in the negotiation and consummation of the acquisition of Dreyfus by [MBC]" and, "[a]s a result, Applicants and other Dreyfus Funds shareholders will be injured by the acquisition." Please advise the Subcommittee of the status of this application, whether it states an appropriate cause of action, and whether and under what circumstances compensation can have an impact on the independence of fund directors.

4. The OCC letter of January 12, 1994 states (p. 9, para. 1) that "Dreyfus would be required to comply with all laws applicable to national banks and would be subject to Banking Circular 274." How do you envision that conflicts between requirements of the banking laws and requirements of the securities laws will be resolved? Please advise us of any discussions between the SEC and OCC on this subject. What

The Honorable Arthur Levitt, Jr.
Page 3

specific progress has been made between the SEC and OCC in coordinating your regulatory responsibilities with respect to entities that are subject both to the federal banking laws and the federal securities laws? Do you presently and do you anticipate in the future engaging in (i) coordinated or (ii) duplicate examination and/or enforcement actions?

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

RECEIVED

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

ARTHUR LEVITT
CHAIRMAN

March 1, 1994

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight and Investigations
Committee on Energy & Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

In your letter to us dated February 23, 1994, you asked several questions about, and requested certain information with respect to, the merger of Mellon Bank Corporation and Dreyfus Corporation. In response to your request, I asked the Commission's staff to prepare the enclosed memorandum.

I hope this memorandum satisfactorily responds to your questions. If you have any further questions, or need additional information, please do not hesitate to contact me.

Sincerely,

Arthur Levitt
Chairman

Enclosure

450 5TH ST NW • WASHINGTON, D.C. 20549 • TEL (202) 272-2000 • FAX (202) 272-3912

MEMORANDUM

March 1, 1994

To: Chairman Levitt

From: Division of Investment Management
Office of General Counsel
Division of Market Regulation

Subject: Letter from Chairman Dingell Requesting Information About Mellon/Dreyfus Merger

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This memorandum responds to requests for information contained in a letter to you dated February 23, 1994, from the Honorable John D. Dingell, Chairman of the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce. The letter requests information about the proposed merger between The Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC). MBC's subsidiary, Mellon Bank, N.A. (Mellon Bank), proposes to acquire Dreyfus, which will function as a separate operating subsidiary of Mellon Bank. The numbered headings below correspond to the numbered paragraphs in Chairman Dingell's letter.

1. Enforcement Matters

The Enforcement Division advises us that the Commission has not instituted any enforcement action against MBC, Mellon Bank, or Dreyfus during the past ten years. In addition, we are not aware of any agreements concerning compliance-related matters to which MBC, Mellon Bank, or Dreyfus is a party, that have been omitted from the index attached to Chairman Dingell's letter. Finally, we know of no patterns of compliance problems or violations by MBC, Mellon Bank, or Dreyfus of a significant nature.

2. Effect of Proposed Merger on Dreyfus Shareholders

Chairman Dingell seeks copies of any information or analyses in the Commission's possession that raise questions about the effect of the proposed merger on the shareholders of Dreyfus, or otherwise indicate that the merger might not be in their best interests. The Division of Corporation Finance advises us that no materials responsive to this request (other than Heine Securities Corporation's Schedule 13D referenced in Chairman Dingell's letter) have been filed with the Commission.

Shortly after announcement of the proposed merger, MBC and Dreyfus each filed a Current Report on Form 8-K that included a joint press release announcing the proposed merger, copies of which are enclosed. The press release describes the proposed

merger and the reasons for it, but does not specifically address the fairness of the proposed merger to Dreyfus shareholders.

MBC and Dreyfus have not yet filed other materials relating to the merger, including proxy materials to seek shareholder approval or a registration statement to register the MBC securities to be issued in the merger under the Securities Act of 1933. When these materials are available, we will forward them promptly to the Subcommittee. If Dreyfus obtained a fairness opinion from an investment bank concerning the merger, it is likely that Dreyfus' proxy materials will include a description of the opinion.

Commission rules generally do not require issuers to provide information to the Commission concerning proposed mergers before they file proxy materials or registration statements relating to the merger. In addition, a registered investment adviser, such as Dreyfus, generally is not required through our recordkeeping requirements to furnish us with material (such as a fairness opinion in connection with a merger) that is not related to its operating activities. Therefore, we have not attempted to obtain information concerning the fairness of the proposed merger from Dreyfus or MBC.

3. Challenge to Independence of Certain Dreyfus Fund Directors

Chairman Dingell seeks information about a request by certain shareholders of Dreyfus funds that the Commission hold a hearing to determine whether individuals who serve as directors of several Dreyfus funds are "interested persons" of those funds. The shareholders argue that individuals who serve on multiple boards receive, in the aggregate, substantial sums of money that impair their independence. The Division of Investment Management is examining the shareholders' request and will make a recommendation to the Commission shortly. Because the Commission eventually may act as an adjudicatory body at a hearing on this matter, we believe it would be inappropriate to comment on the merits of the request at this time.

As a general matter, we believe the independence of investment company directors is one of the most important safeguards protecting investment company shareholders. The Commission recently proposed amendments to the proxy rules for registered investment companies that address the specific issue of director compensation. 1/ The amendments are intended, among other things: to clarify the presentation of director compensation; to provide better disclosure of benefits other than

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1/ See Amendments to Proxy Rules for Registered Investment Companies, Investment Company Act Rel. No. 19957 (Dec. 16, 1993), 58 Fed. Reg. 67729 (Dec. 22, 1993).

compensation that are received by a director; and, for directors who serve on the boards of more than one fund in a fund complex, to furnish more comprehensive information about the directors' total compensation. The comment period relating to the Commission's proposal closes on March 18, 1994.

4. Regulatory Conflicts

The final question asked by Chairman Dingell in his letter relates to conflicts that will be faced by Dreyfus in meeting the requirements of both the banking and securities laws, and what coordination efforts have been made by the Commission and the Office of the Comptroller of the Currency (OCC) to resolve these conflicts.

Conflicts. In 1993, the OCC and the three other federal banking regulators separately issued "guidelines" designed to address some of the investor protection issues raised by bank securities and mutual fund sales. 2/ Two weeks ago, the banking agencies issued a joint interagency statement intended to consolidate, standardize, and supersede the earlier, separate guidelines. 3/

Unfortunately, both the OCC guidelines and the interagency guidelines raise serious potential problems of regulatory overlap and conflict. For example, both sets of guidelines apparently contemplate some form of banking regulator oversight for registered broker-dealers that assist banks in the sale of securities products. Since broker-dealers already are subject to comprehensive Commission and self-regulatory organization (SRO) regulation under the federal securities laws, imposing an additional layer of banking regulator oversight could produce regulatory conflict over the applicable standards of conduct, as well as unnecessary and duplicative examinations.

Conflict is also possible, and indeed has already arisen, with respect to disclosure requirements. The OCC and interagency guidelines governing sales of securities (including money market funds) to bank customers require, among other things, prospectus

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2/ See OCC Banking Circular No. 274 (July 19, 1993); see also letter from Richard Spillenkothen, Director, Federal Reserve Division of Banking Supervision and Regulation, on "Separation of Mutual Fund Sales Activities from Insured Deposit-Taking Activities" (June 17, 1993); FDIC Supervisory Statement on State Nonmember Bank Sales of Mutual Funds and Annuities (Oct. 8, 1993); OTS Bulletin 23-1, "Guidance on the Sale of Uninsured Products" (Sept. 7, 1993).

3/ See "Interagency Statement on Retail Sales of Nondeposit Investment Products," Feb. 15, 1994, at 2, n.1.

disclosure of "investment risks, including the possible loss of principal." By contrast, Commission prospectus disclosure requirements specifically tailored for money market funds mandate disclosure that "there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share." Seeking to avoid "inconsistent and duplicative disclosures," the Investment Company Institute (ICI) recently wrote to the Comptroller requesting clarification that disclosures conforming to Commission and National Association of Securities Dealers requirements will satisfy the standards set forth in the banking guidelines. 4/ Representatives of the OCC, the Federal Reserve Board, the Office of Thrift Supervision, and the Commission met last week in an attempt to resolve the issue raised by the ICI.

Conflict between the banking guidelines and the federal securities laws could affect the Commission's ability to discipline broker-dealers for failure to supervise their employees. Under the federal securities laws, registered broker-dealers are subject to sanctions for failure to adequately supervise their employees, and broker-dealers are subject to controlling person liability for employees who engage in violations of the federal securities laws. The banking guidelines are much less comprehensive. The guidelines advise senior bank management to designate specific individuals to exercise supervisory responsibility for securities sales; state that "[d]epository institution personnel with supervisory responsibilities should receive training appropriate to that position"; and state that banks should adopt procedures for monitoring compliance by third parties (e.g., broker-dealers that have networking arrangements with banks). These differing provisions may create confusion (and, ultimately, conflicting positions) regarding the supervisory responsibilities in a bank-affiliated broker-dealer.

Finally, we note that these conflicts are illustrative only, and are not intended to be exhaustive. As the Commission has noted on other occasions, there are a wide range of additional issues regarding the adequacy of the oversight of bank securities activities outside of the securities regulatory framework. We continue to believe that, with respect to bank securities activities, investor protection and the maintenance of fair and orderly markets only can be achieved through direct application of the securities laws.

Resolution of conflicts. At present, no mechanism exists for resolving the conflicts that may arise between the federal banking laws and the federal securities laws as applied to banks

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4/ See letter from Paul Schott Stevens, ICI General Counsel, to William P. Bowden, Jr., OCC Chief Counsel (Jan. 17, 1994) (copy attached).

and their affiliates engaged in the mutual fund business. Over the past four months, representatives of the Divisions of Investment Management, Market Regulation, and Enforcement, and of the Office of the General Counsel have had exploratory discussions with OCC staff to consider joint inspections of bank-affiliated mutual funds and coordination of enforcement actions, including the possibility of instituting joint enforcement actions against several entities that are registered with the OCC as transfer agents. The discussions are continuing, but no formal agreements or timetables have yet been reached. Without such agreements, banking and securities regulators continue to engage in unnecessarily overlapping activity. We understand, for example, that federal banking regulators currently are examining registered broker-dealers who engage in securities activities on the premises of banks, but the Commission has not been alerted to specific examinations in advance.

The Commission and the OCC recently have undertaken joint empirical research relating to, and contemplate conducting a joint survey of, investor perceptions of mutual funds advised or distributed by banks. Moreover, the Division of Market Regulation has commenced discussions with the SROs relating to the examination protocol of their member firms that are affiliates of banks or that are providing securities services to bank customers through "networking" arrangements. These discussions will be directed at the frequency of examinations, as well as the depth of the sales practice reviews needed for these types of broker-dealers. Additionally, the Division of Market Regulation intends to pursue discussions with the bank regulators relating to their need to have access to non-bank brokerage books and records.

We believe that the meetings between Commission and banking regulatory staff held to date are important steps toward better cooperation and coordination of regulatory efforts involving mutual funds. We hope that we will be able to use these new channels of communication as we address conflicts that arise between the federal banking laws and the federal securities laws in connection with the sale of mutual funds and other securities by banks and their affiliates. In the final analysis, however, we believe that coordination between the securities and banking regulators, although important, cannot be more than a temporary fix of a systemic problem, because the two sets of regulators are subject to different legislative mandates. The real solution, in our view, must be legislative, and we reaffirm our support for Chairman Dingell's "functional regulation" bill (the Securities Regulatory Equality Act, H.R. 3447) that would prescribe the same regulatory scheme for all entities engaged in the mutual fund industry.

INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
GENERAL COUNSEL

January 17, 1994

William P. Bowden, Jr., Esquire
Chief Counsel
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Re: Money Market Mutual Fund Disclosure Requirements

Dear Mr. Bowden:

The Investment Company Institute[1] is writing to urge that the Office of the Comptroller of the Currency ("OCC") address a significant problem that has arisen as a result of its July 19, 1993 guidelines concerning bank sales of mutual funds and other nondeposit products.

As you know, the Institute has strongly supported the adoption of uniform guidelines for the bank sale of mutual funds and other nondeposit products. For this reason, in July 1993 the Institute submitted model guidelines to the OCC as well as other federal regulatory agencies. We are pleased that each of the federal banking regulators has issued its own regulatory guidelines in this area.

These guidelines are intended to provide important protections for bank customers and investors. Insofar as there are significant inconsistencies among the guidelines of the different agencies, however, this objective will be more difficult to achieve. The Institute is particularly concerned about the OCC's standard mutual fund disclosure language as it applies to money market funds, because it is inconsistent with current disclosure requirements of the Securities and Exchange Commission.

The Comptroller's guidelines state that when uninsured investment products are sold or marketed to retail customers,

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1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 4,582 open-end investment companies ("mutual funds"), 433 closed-end investment companies and 13 sponsors of unit investment trusts. Its mutual fund members have assets of about $1.92 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders.

William P. Bowden, Jr., Esquire
January 17, 1994
Page 2

there must be prominent disclosure that the products are not FDIC-insured or obligations of or guaranteed by the bank, and that they "involve investment risks, including the possible loss of principal." This disclosure would have to appear conspicuously in all written or oral sales presentations, advertising, prospectuses, and periodic statements that include information on both deposit and nondeposit products.

By contrast, the SEC requires that all advertisements containing performance information concerning money market funds and prospectuses for those funds disclose that:

> (1) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[2]

Disclosure in the above form was mandated by the SEC in 1991 and is now standard throughout the industry.

With respect to the risk of loss of principal, this disclosure accomplishes the same purpose as the Comptroller's disclosure but is, in our view, tailored more precisely to the characteristics of money market funds. The SEC's disclosure makes clear that, despite the fund's objective of maintaining a stable net asset value of $1.00 per share, there can be no assurance that this objective will be met.

The SEC also requires prominent, cover-page disclosure on every prospectus for a mutual fund sold by or through a bank (including a money market fund), of the fact that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank . . . ."[3] The National Association of Securities Dealers, Inc., requires that advertisements for mutual funds sold through banks (including money market funds) disclose that the fund shares "are not deposits or obligations of, or

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2 Rule 482(a)(7); Item 1, Form N-1A. The SEC also has proposed to amend Rule 134, to require inclusion of this disclosure in so-called "tombstone advertisements" that generally describe money market funds. See SEC Release No. IC-19959 (December 17, 1993).

3 See Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993).

William P. Bowden, Jr., Esquire
January 17, 1994
Page 3

guaranteed by, the bank . . . ."[4]

In order to avoid inconsistent and duplicative disclosures, the Institute urges the Comptroller to clarify that money market fund advertisements and prospectuses containing the SEC- and NASD-required language will satisfy relevant requirements contained in the OCC's guidelines. Alternatively, should the OCC conclude that disclosure in the form mandated to date by the SEC and the NASD is in some respect deficient, we urge that it consult and coordinate with the SEC and the NASD on some single revised disclosure format acceptable to all three agencies. Either approach would be distinctly preferable to the current situation.

We would be pleased to provide any additional information concerning this matter. We have sent similar letters to the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

Very truly yours,

Paul Schott Stevens
General Counsel

cc: Barry Barbash
Director, Division of Investment Management
Securities and Exchange Commission

R. Clark Hooper
Vice President, Advertising/Investment Companies Regulation
National Association of Securities Dealers, Inc.

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[4] See NASD Notice to Members 93-87 (December 1993). The NASD'S disclosure requirement applies to bank-affiliated members and members participating in bank networking arrangements. The NASD's Notice also requires its members to advise their bank affiliates that their unregistered employees should provide similar disclosure.

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported) - December 6, 1993

MELLON BANK CORPORATION
(Exact name of registrant as specified in charter)

Pennsylvania	1-7410	25-1233834
(State or other jurisdiction of incorporation)	(Commission File Number)	(I.R.S. Employer Identification No.)

One Mellon Bank Center
500 Grant Street
Pittsburgh, Pennsylvania 15258
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code - (412) 234-5000

ITEM 5. OTHER EVENTS

Mellon Bank Corporation (the "Corporation") announced that it has entered into a definitive agreement to merge with The Dreyfus Corporation ("Dreyfus") in a transacation valued at $1.85 billion. Under the terms of the agreement, which provides for a tax-free transaction accounted for as a pooling of interests, Dreyfus shareholders will receive .88017 shares of the Corporation's common stock for each of the 36.6 million Dreyfus shares outstanding.

ITEM 7. FINANCIAL STATEMENTS AND EXHIBITS

Exhibit Number	Description
99.1	Joint press release dated December 6, 1993, of Mellon Bank Corporation and The Dreyfus Corporation announcing the definitive agreement to merge the two entities.

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MELLON BANK CORPORATION

Date: December 7, 1993

By: /s/ James M. Gockley

James M. Gockley
Assistant General
Counsel and Secretary

EX-99.1

LOGO OF MELLON BANK CORPORATION Mellon Bank	LOGO OF DREYFUS CORPORATION Dreyfus Corp.

	Mellon	Dreyfus
ANALYSTS:	Charles M. Johnston 212-371-5999 (Dec. 6) 412-234-5601	Philip L. Toia 212-922-6265
MEDIA:	Thomas W. Butch 212-371-5999 (Dec. 6) 412-234-6436	Diane M. Coffey 212-371-5999 (Dec. 6) 212-922-6070

FOR IMMEDIATE RELEASE

MELLON BANK CORPORATION AND THE DREYFUS CORPORATION TO MERGE IN STOCK TRANSACTION VALUED AT $1.85 BILLION

PITTSBURGH and NEW YORK CITY, Dec. 6, 1993 -- Mellon Bank Corporation and The Dreyfus Corporation today jointly announced a definitive agreement to merge, in a landmark transaction valued at $1.85 billion.

In a joint statement, Frank V. Cahouet, chairman, president and chief executive officer of Mellon Bank Corporation, and Howard Stein, chairman and chief executive officer of The Dreyfus Corporation, said: "This merger is a milestone in the history of financial services in the United States, uniting two of its most respected names. As the financial services industry continues to evolve, and providers from various of its sectors continue to come together, we will set a new standard that we hope will inspire others.

-more-

Mellon, Dreyfus To Merge
Dec. 6, 1993

"This is more than the joining of two major American business organizations. It is a melding of people, financial strengths and names that, over time, have consistently been associated with integrity, innovation and dedication to fiduciary care and deep personal trust. When two great business traditions join together for the future benefit of their customers and the industry, it is a signal event in the financial world.

"In an ever more complicated marketplace these two organizations, which have played so prominent a role in our nation's financial history, now are defining its future. Together, Mellon and Dreyfus will be uniquely positioned to meet the public's growing desire for a complete array of high-quality financial products delivered by a single source committed to impeccable standards."

Mellon currently provides to its customers an array of uninsured products and has in place policies, procedures and employee training for those products which are in keeping with current regulatory requirements. Building on those policies and practices, and consistent with both firms' historic reputations for ethical conduct and concern for their customers, Mellon and Dreyfus said they plan to adopt a new policy statement for post-merger operations which is designed to implement the spirit of recent Congressional proposals.

The merger of Mellon, a leading bank holding company, and Dreyfus, the nation's sixth-largest mutual fund company, will create a diversified financial services organization with revenues of more than $3 billion, including fee revenues of about $1.6 billion, and approximately $215 billion in funds under management as well as $615 billion in funds under administration.

Under terms of the agreement, Dreyfus shareholders will receive .88017 shares of Mellon Bank Corporation common stock for each of the 36.6 million Dreyfus shares outstanding. Based on the Mellon Bank Corporation common stock closing price of $57.375 at Dec. 3, 1993, the transaction has an indicated value of $50.50 per Dreyfus common share and a total value of $1.85 billion.

The Corporation will account for this transaction as a pooling of interests, and the transaction will be tax-free to Dreyfus shareholders.

In connection with the transaction, the Corporation expects to record a one-time after tax charge to earnings of approximately $73 million, reflecting various integration expenses. The charge is expected to be recorded at closing, which is anticipated in mid-1994, pending regulatory approvals and approvals by the shareholders of Mellon Bank Corporation and Dreyfus, all of which are expected. The transaction has been approved by the boards of directors of both Mellon and Dreyfus.

-more-

As a result of this transaction, the Corporation anticipates that its earnings per share growth will slow somewhat for the next two years; nonetheless, it expects earnings per share growth to remain substantial over that period.

On a pro forma basis reflecting the merger, Mellon Bank Corporation's return on assets would improve to about 1.5 percent and its proportion of fee revenue relative to total revenue would increase to 52 percent. In addition, the Corporation's common equity, tangible common equity and leverage capital ratios would improve to approximately 9.5 percent, 6.3 percent and 8.9 percent, respectively.

The merger agreement provides for a $50 million termination fee, payable by Dreyfus to Mellon in certain events. Howard Stein and Joseph S. DiMartino, president and chief operating officer of Dreyfus, have committed in their capacity as shareholders to vote their shares in favor of the Mellon merger and not to vote their shares for a transaction with any other party.

Dreyfus will retain its New York headquarters and will remain a freestanding organization within Mellon Bank Corporation. The Dreyfus management team and the Dreyfus fund managers remain in place, and the Dreyfus name will be retained for the mutual funds it manages.

Stein, DiMartino and Edward J. McAniff, a partner in the Los Angeles law firm of O'Melveny & Myers, will be nominated for election to the board of directors of Mellon Bank Corporation. Stein and DiMartino will retain their respective roles at Dreyfus.

Formed in 1951 and publicly owned since 1965, Dreyfus is the sixth-largest mutual fund company in the United States. Since the end of 1988, Dreyfus has doubled its assets under management and administration, to approximately $80 billion in over 130 mutual funds, including money market, bond and equity funds. Headquartered in New York City, it employs approximately 2,000. It operates 16 Dreyfus Financial Centers in major cities throughout the United States.

Mellon Bank Corporation is a major bank holding company headquartered in Pittsburgh. Through its subsidiaries, Mellon provides a broad array of financial products and services to individuals and small businesses in the Central Atlantic states of Pennsylvania, Delaware and Maryland; to mid-sized companies throughout the Central Atlantic region; and to large corporate and institutional customers throughout the United States and in select international markets.

-more-

Mellon, Dreyfus To Merge
Dec. 6, 1993

In addition to providing lending and deposit services, the Corporation is a leader in providing trust and investment, cash management, and mortgage banking products and services, and currently derives approximately 50 percent of its annual revenues from these and other fee-based activities.

In its trust and investment activities--which include mutual fund administration, Master Trust and custody, institutional investment management and personal trust, provided under the name "Mellon Trust"--the Corporation administers approximately $615 billion in assets, and manages $135 billion in assets.

The Corporation's balance sheet assets of approximately $35 billion at Sept. 30, 1993, rank it as the nation's 21st largest bank holding company by that measure. On a pro forma basis including Dreyfus, the Corporation expects to generate annual revenues of more than $3 billion, ranking it as the nation's 13th largest bank holding company by that measure.

"This partnership with one of the great names in mutual funds continues Mellon's evolution into a full-service financial services company with a bank as its core," Cahouet said. "It represents a significant enhancement of our present proprietary and administrative mutual fund business, strengthens our balance between lending and nonlending businesses, and greatly enhances our growth prospects going forward. This is a meaningful step in our ongoing effort to build the financial institution of the future."

"Dreyfus has long stood for strength, stability, integrity and prudence," Stein said. "We were interested in merging with Mellon because we believe Mellon shares those qualities and, like us, has a deep and abiding respect for its customers and shareholders. Dreyfus was founded on the concept of providing to the many the financial services once reserved for the few. Our partnership with Mellon will take the spirit of that commitment into the next century and strengthen forever our ongoing capacity to meet our customers' ever-changing needs."

-more-

NOTE: FRANK CAHOUET, CHAIRMAN, PRESIDENT AND CEO OF MELLON BANK CORPORATION, AND HOWARD STEIN, CHAIRMAN AND CEO OF THE DREYFUS CORPORATION, WILL BRIEF INVESTORS/ANALYSTS AND MEMBERS OF THE MEDIA ON THE MERGER OF MELLON AND DREYFUS:

Investor/Analyst Meeting:

Date:	Today, December 6, 1993
Time:	10 a.m.
Place:	St. Regis Hotel 2 East 55th Street (at Fifth avenue) Fontainebleu Room, 2nd floor

Investors who wish to participate in the briefing via conference call should call Ann Beltrani at 212-371-5999 before 9:45 a.m.

Press Conference:

Date:	Today, December 6, 1993
Time:	11:30 a.m.
Place:	The OMNI Berkshire Hotel 21 East 52nd Street (between Madison and Fifth) Madison Room, 2nd floor

Members of the media who are not able to attend the press conference will be able to participate via conference call. The telephone number is 1-800-701-9363. R.S.V.P. to Abernathy Macgregor Scanlon at 212-371-5999.

Contacts:

New York:	At Abernathy Macgregor Scanlon, 212-371-5999
Investors:	Chuck Johnston, Mellon Bank Corporation
Media:	Thomas Butch, Mellon Bank Corporation Diane Coffey, The Dreyfus Corporation
New York: Investors:	Philip Toia, The Dreyfus Corporation 212-922-6265
Pittsburgh: Media:	Margaret Cohen, Mellon Bank Corporation 412-234-0850

# # #

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

DEC 7 1993

FORM 8-K

CURRENT REPORT
Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): December 6, 1993

THE DREYFUS CORPORATION
(Exact name of registrant as specified in its charter)

New York	1-5240	13-5673135
(State or other jurisdiciton of incorporation)	**(Commission File Number)**	**(IRS Employer Identification No.)**

200 Park Avenue New York, NY	10166
(Address of Principal executive offices)	**(Zip Code)**

(212) 922-6000
(Registrant's telephone number, including area code)

ACC0D941.WP5

Item 5. Other Events.

On December 6, 1993, the Company announced that it had executed an Agreement and Plan of Merger with Mellon Bank Corporation, Mellon Bank and XYZ Sub Corporation, a subsidiary of Mellon Bank. Attached hereto and included by reference is a press release dated December 6, 1993 announcing the proposed merger transaction.

Item 7. Financial Status and Exhibits.

c. Exhibits

20.1 Press Release dated December 6, 1993 announcing the execution of the Agreement and Plan of Merger by and among The Dreyfus Corporation, Mellon Bank Corporation, Mellon Bank and XYZ Sub Corporation, a subsidiary of Mellon Bank.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

THE DREYFUS CORPORATION

By: /s/ Daniel C. MacLean
Daniel C. MacLean
Vice President and General Counsel

Date: December 7, 1993

ACC0D941.WP5

EXHIBIT 20.1

Mellon Bank

Dreyfus

	Mellon	Dreyfus
ANALYSTS:	Charles M. Johnston 212-371-5999 (Dec. 6) 412-234-5601	Philip L. Toia 212-922-6265
MEDIA:	Thomas W. Butch 212-371-5999 (Dec. 6) 412-234-6436	Diane M. Coffey 212-371-5999 (Dec. 6) 212-922-6070

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-more-

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"In an ever more complicated marketplace these two organizations, which have played so prominent a role in our nation's financial history, now are defining its future. Together, Mellon and Dreyfus will be uniquely positioned to meet the public's growing desire for a complete array of high-quality financial products delivered by a single source committed to impeccable standards."

Mellon currently provides to its customers an array of uninsured products and has in place policies, procedures and employee training for those products which are in keeping with current regulatory requirements. Building on those policies and practices, and consistent with both firms' historic reputations for ethical conduct and concern for their customers, Mellon and Dreyfus said they plan to adopt a new policy statement for post-merger operations which is designed to implement the spirit of recent Congressional proposals.

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-more-

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Investors:	Chuck Johnston, Mellon Bank Corporation
Media:	Thomas Butch, Mellon Bank Corporation Diane Coffey, The Dreyfus Corporation

New York:

Investors:	Philip Toia, The Dreyfus Corporation 212-922-6265

Pittsburgh:

Media:	Margaret Cohen, Mellon Bank Corporation 412-234-0850

# # #

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

March 2, 1994

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

In connection with the Subcommittee hearings today and tomorrow on this matter, serious concerns have been raised regarding the adequacy of the protections that the banking laws afford customers who purchase securities or investment advice in banks. Accordingly, I am transmitting the enclosed 55-page draft table comparison of the regulation of broker-dealers and investment advisers under the federal securities laws versus under the federal banking laws. The table summarizes the principal relevant statutes, regulations, and guidelines administered by the Securities and Exchange Commission and by the federal banking agencies. The Subcommittee will be keeping the hearing record open for 30 days to accommodate our request that you carefully review this document and submit any corrections you deem necessary to make this table accurate and complete.

If you have any questions about this request, please contact Consuela M. Washington of the staff at (202) 225-3147. Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

Enclosure

cc: The Honorable Dan Schaefer

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

RECEIVED
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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

March 22, 1994

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
U.S. House of Representatives
Rayburn House Office Building
Washington, D.C. 20515-6116

Dear Chairman Dingell:

To respond to your letter of March 2, 1994, I asked the SEC staff to review your draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and under the federal banking laws.

Specific comments have been marked directly on the table. In reviewing the table, the staff addressed only those portions relating to the regulation of broker-dealers and investment advisers under the federal securities laws. As an initial matter, you should note that the table does not include all the federal securities laws and rules, nor does it address the regulation of banks as transfer agents, municipal or government securities dealers. This, however, is consistent with the table's stated scope, which is to summarize "the principal statutes, regulations, and guidelines governing broker-dealers and investment advisers."

When finalized to include the comments that you have solicited from the various federal agencies, the table should be a useful guide in comparing the regulatory schemes for broker-dealers and investment advisers under the federal securities laws and the federal banking laws. The table demonstrates the significant differences between the two regulatory schemes and highlights the need for legislation -- such as your bill, H.R. 3447 -- to provide for the functional regulation of all securities activities.

If you have any further questions regarding the table, please contact Kathryn Fulton, Director of the Office of Legislative Affairs. The Commission appreciates your leadership in this area and looks forward to continuing to work with you on efforts to strengthen and rationalize the regulation of the U.S. financial services system.

Sincerely,

Arthur Levitt
Chairman

Enclosure

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 31, 1994

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

This is with reference to the Subcommittee's letter of March 2, 1994 asking you to review our draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and under the federal banking laws. The table does not include all the federal securities laws and rules, nor does it address the regulation of banks as transfer agents, municipal, or government securities dealers. This is consistent with the scope of the Subcommittee's inquiry as well as the table's stated scope.

At the request of the Office of the Comptroller of the Currency, we are extending the deadline for your responses to the close of business on Friday, April 8, 1994, at which time we will be closing the hearing record and taking the steps to go to prompt printing. It would be helpful if the recipients of the March 2 letter would meet and discuss (and where possible coordinate) your responses. In any event, your transmittal letters for your corrections should indicate the name and phone number of a contact person on your staff, in the event that we have questions about your submission.

The Subcommittee greatly appreciates your cooperation and assistance with our work. We firmly believe that these issues are of vital importance to the protection of the public.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer
The Honorable Alan Greenspan
The Honorable Andrew C. Hove
The Honorable Eugene A. Ludwig

ONE HUNDRED THIRD CONGRESS

JOHN D. DINGELL, MICHIGAN, CHAIRMAN

SHERROD BROWN, OHIO
MARJORIE MARGOLIES-MEZVINSKY, PENNSYLVANIA
HENRY A. WAXMAN, CALIFORNIA
CARDISS COLLINS, ILLINOIS
RON WYDEN, OREGON
JOHN BRYANT, TEXAS
DAN SCHAEFER, COLORADO
CARLOS J. MOORHEAD, CALIFORNIA
FRED UPTON, MICHIGAN
PAUL E. GILLMOR, OHIO

REID P.F. STUNTZ, STAFF DIRECTOR/CHIEF COUNSEL

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 226-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 11, 1994

The Honorable Arthur Levitt, Jr.
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank corporation whereby Dreyfus will be acquired by Mellon Bank, N.A. as a separate operating subsidiary.

In connection with your testimony at the Subcommittee hearing on March 2, 1994, this is to request that you provide for inclusion in the record the following responses, information and documents by the close of business on Monday, March 28, 1994.

1. Please clarify your response to our question (Tr. pp. 19-20) about the impact of limited SEC budget and staff resources on your ability to meet the demands of a larger class of regulated entities should Congress repeal the bank broker-dealer and investment adviser exemptions under the federal securities laws.

2. You were asked (Tr. p. 27) to explain the difference between FDIC insurance and SIPC insurance, and your response contained some errors. Please provide a complete comparison of these two insurance schemes.

3. As requested (Tr. p. 66), please submit a report on the progress of the SEC and OCC in coordinating your respective examination and enforcement programs. Your report should include a list of the dates, participants, and summaries of any and all interagency meetings on this subject, and copies of any memoranda of understanding between SEC and OCC with respect to the terms and conditions of such joint examination and enforcement programs. Your report also should include all relevant details and documents, with an explanation of whether they show cooperation or the lack thereof, with respect to the SEC and OCC enforcement

The Honorable Arthur Levitt, Jr.
Page 2

actions against Citibank (Tr. pp. 67-68) which matter you testified involved "a jurisdictional dispute." Please advise the Subcommittee of any similar problems involving OCC or any other federel bank regulatory agency.

If you have any questions about this request, please contact Consuela M. Washington of the staff at (202) 225-3147. Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

RECEIVED
94 MAR 35 AM 9 32
ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

April 4, 1994

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
House Committee on Energy and Commerce
Rayburn House Office Building
Washington, D.C. 20515-6116

Dear Chairman Dingell:

This responds to your letter of March 11, 1994, which posed a number of questions following up on my March 2nd testimony before the Subcommittee on Oversight and Investigations. Enclosed are my answers to questions 1 and 2, and to portions of question 3, contained in the March 11th letter. I am submitting my answer to the remainder of question 3 under separate cover.

I understand that the enclosed materials will supplement my testimony before the Subcommittee regarding the proposed merger between The Dreyfus Corporation and The Mellon Bank Corporation, and the related issue of functional regulation of bank securities activities. The Commission appreciates your leadership in this area, and looks forward to continuing to work with you to achieve passage of H.R. 3447.

If you have any further questions, please contact me or Kathryn Fulton, Director of the Office of Legislative Affairs.

Sincerely,

Arthur Levitt

enclosures

APPENDIX A

CHAIRMAN LEVITT'S ANSWERS TO CHAIRMAN DINGELL'S FOLLOW-UP QUESTIONS

1. **Staffing and Resource Requirements Associated with the Regulation of Bank Broker-Dealers and Investment Advisers**

As you know, the Commission generally has a critical need for resources, and greatly appreciates Chairman Dingell's continuing efforts to champion the cause of Commission self-funding.

Resources are not the key consideration, however, when it comes to the issue of Commission regulation of bank broker-dealers and investment advisers. Unlike the bank regulatory scheme, our system of securities regulation relies on several factors that minimize the need for the vast number of personnel employed by the bank regulatory agencies. These include: the deterrent effect of a strong enforcement presence that receives widespread publicity; market discipline; and the efforts of the National Association of Securities Dealers, Inc. ("NASD"), the New York and other stock exchanges, and other self-regulatory organizations ("SROs"), which supplement the work of the Commission.

If bank broker-dealer activities were registered, the Commission would need to hire few, if any, additional personnel. Bank broker-dealers would be required to become members of the NASD and might become members of the New York Stock Exchange, Inc. or other SROs and would be subject to SRO supervision and inspection. They would pay dues to the NASD, which would enable the NASD, in turn, to expand its supervisory and examination functions.

Similarly, the adoption of legislation requiring bank advisers to register with the Commission should not necessitate hiring a substantial number of new examiners. Commission examiners already examine bank-affiliated mutual funds. A Commission mutual fund examination typically includes an inspection of the investment adviser's records with respect to both its mutual fund and other advisory clients. Under the present statutory scheme, however, Commission examiners have express authority to inspect a fund advised by a bank, but lack express authority to inspect records maintained by the bank that relate to advisory clients that are not mutual funds. As a result, Commission examiners are hamstrung when it comes to bank adviser inspections. Changing the regulatory scheme would result in examiners being able to conduct comprehensive inspections that might reveal, for example, that an adviser is favoring certain private clients at the expense of a fund and its shareholders. Expanding inspections of bank-advised funds would <u>not</u>, however, require a large corps of additional inspectors. It simply would make inspections that the Commission already conducts more comprehensive and thorough.

Enactment of the investment advisers legislation currently pending in both Houses of Congress would mean that the costs of overseeing and examining banks that register as investment advisers would be borne by the industry, not the Commission. As you know, the legislation would amend the Investment Advisers Act of 1940 to require registered investment advisers to pay the entire cost of the investment adviser inspection program. Registered investment advisers would pay annual fees to the Commission based on the amount of assets under management. These annual fees would enable the Commission to hire additional staff and to examine registered investment advisers much more frequently.

2. Comparison of SIPC and FDIC Insurance

In 1970, Congress adopted the Securities Investor Protection Act ("SIPA"), which established the Securities Investor Protection Corporation ("SIPC"), a membership corporation designed to protect investors from financial hardship and markets from disruption due to the failure of member financial institutions. Generally, SIPA provides that all persons registered with the Commission as broker-dealers under Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") are members of SIPC. Persons registered with the Commission as government securities broker-dealers under Section 15C of the Exchange Act are not members of SIPC. In addition, the following persons are excluded from SIPA's membership requirement: (1) persons whose principal place of business is outside the United States and (2) persons engaged in a business that consists exclusively of (a) the distribution of shares of an open-end investment company or unit investment trust,1/ (b) the sale of variable annuities, (c) the sale or provision of insurance, or (d) the provision of advisory services to a registered investment company or insurance company separate account.2/

As noted above, SIPC protects only customers of SIPC member broker-dealers. If a SIPC member broker-dealer fails, mutual fund shares held by the broker-dealer in a customer's securities account would be covered to the same extent that any other security would be protected. Of note is the fact that mutual fund shares often are held in the custody of non-SIPC members (e.g., broker-dealers that engage only in the distribution of shares of an open-end investment company or unit investment trust). Thus, mutual fund

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1/ It should be noted that SIPC would cover the loss of an investor who held shares of an open-end investment company if the investor's broker-dealer, who is a member of SIPC, was unable to deliver the shares of such investment company.

2/ In addition, SIPA may not protect a lender of securities in a securities loan transaction. SIPC has taken the position that SIPA does not protect the counterparty to a repurchase agreement. See Commission Rule 15c3-3(b)(4)(iii).

shares would receive no SIPC protection if they are in the custody of a non-SIPC member that fails. If an investor purchases mutual fund shares through an investment adviser that is dually registered as a SIPC member broker-dealer and the entity fails, those mutual fund shares held by the broker-dealer would be covered by SIPC. If an investor purchases mutual fund shares through an investment adviser that fails, and the adviser is not dually registered as a SIPC member broker-dealer, SIPC will not protect cash or securities in the adviser's possession.

The protection provided by SIPC is triggered solely by the failure of a member. SIPC's responsibility is limited to customer accounts. Coverage is limited to $500,000 for claims for cash and securities. Of this amount, no more than $100,000 may be claimed for cash. In a SIPC liquidation, customer property is allocated on a pro rata basis to customers of a failed broker-dealer. To the extent that shortfalls exist, amounts are paid from the SIPC fund up to the limits mentioned above.

SIPC does not protect investors from investment risk and losses on securities due to market fluctuations. Thus, for example, if an investor purchases securities having a market value of $100,000 and market changes depreciate the value of those securities to $50,000, on filing date the investor cannot recover the lost $50,000 from SIPC. In contrast, the insurance provided by the Federal Deposit Insurance Corporation ("FDIC") protects deposits for the full amount of the deposit, up to $100,000. Such deposits may be used by FDIC member institutions to make loans or other investments on behalf of the institution.

SIPC is not designed to keep securities firms (or mutual funds) from failing or to shield customers from changes in the market value of their investment. Rather, SIPC has the limited purpose of insuring that when member broker-dealers fail, or otherwise go out of business, customers will receive the cash and securities they own, up to the SIPC limits. The FDIC, by contrast, shares responsibility with the other federal banking regulators for protecting bank safety and soundness and the health of the federal deposit insurance system generally. The FDIC, moreover, operates as an agency of the federal government, and FDIC officials are authorized to inspect the premises of FDIC-member institutions. SIPC does not have similar authority for SIPC members; such authority is assigned to the Commission and SROs.

3. Progress of the SEC and OCC in Coordinating Examination and Enforcement Programs

Attached as Appendix B is a staff memorandum discussing recent SEC-OCC coordination efforts involving our respective examination and enforcement programs.

As you requested, at the end of the attached memorandum is a list of meetings between SEC staff and banking agency staff regarding examination and enforcement programs. Included among these meetings are several between Comptroller Ludwig and me. These staff meetings have been helpful and productive to a point. However, no "formal" agreement or arrangement has yet been reached regarding sharing of information or specific collaboration.

In the final analysis, these efforts are stop-gap measures -- they make the best of a bad situation by relying on personal relationships and goodwill between individuals currently at each agency. In the longer run, joint regulatory and inspection efforts cannot substitute for institutional relationships grounded in sound public policy and written into law that will survive long after the current regulators have left office. The real solution is therefore legislative reform: the adoption of legislation providing for functional regulation of all entities engaged in the securities industry.

APPENDIX B

MEMORANDUM

March 31, 1994

TO: Chairman Levitt

FROM: Division of Enforcement
Division of Market Regulation
Division of Investment Management
Office of General Counsel

SUBJECT: SEC and OCC Efforts to Coordinate Examination and Enforcement Programs

Pursuant to Chairman Dingell's March 11, 1994 letter following up on your March 2, 1994 testimony before the House Subcommittee on Oversight and Investigations, you have asked us to describe the progress of the Commission and the Office of the Comptroller of the Currency ("OCC") in coordinating our respective examination and enforcement programs.

Examinations. At present, no comprehensive mechanism exists for coordinating examination efforts of the Commission and the federal banking regulators. Over the past four months, representatives of the Commission's Office of General Counsel and its Investment Management and Market Regulation Divisions have had exploratory discussions with staff from the OCC to consider joint inspections of banks and their affiliated mutual funds. Those discussions are continuing, but formal agreements and timetables have not yet been reached.

No definitive discussions have been held in connection with the recent OCC decision to engage in overlapping examinations of registered broker-dealers who engage in securities activities on the premises of banks. Despite its request, the Commission staff has not been consulted about OCC examination guidelines. Furthermore, the Commission has not been alerted to specific examinations in advance.

The Commission and the federal banking agencies have, however, taken a number of steps to coordinate their efforts in other areas. For example, the Commission staff coordinates on a regular basis with the OCC, Federal Reserve Board ("FRB"), and the FDIC regarding routine examinations by the banking agencies of bank transfer agents (entities regulated pursuant to Section 17A of the Exchange Act). The Commission, as a member of the Working Group on Treasury Market Surveillance, also confers on a regular basis (every two weeks) with the Federal Reserve Bank of New York regarding Treasury market surveillance. Recently, the Commission and the OCC have undertaken joint empirical research relating to investor

perceptions of bank-advised and bank-sold mutual funds, and anticipate conducting joint follow-up research.

Enforcement. There is likewise no comprehensive mechanism for coordinating enforcement efforts of the Commission and the OCC. The majority of interaction between the Division of Enforcement and the OCC has been in the area of access to OCC documents and examiners in the context of specific investigations and enforcement actions. Particularly in matters involving the accuracy of disclosures concerning the financial condition of public banks and holding companies, Commission enforcement staff has looked to the OCC as a critical source of information concerning the composition and strength of the banks' loan portfolios and the reliability of the banks' risk-rating procedures. The OCC, which performs comprehensive supervisory reviews of banks and provides ongoing monitoring, generally memorializes its findings in Reports of Supervisory Activity ("ROSAs"), as well as in other memoranda, examination workpapers, notes, correspondence, and other documents. These materials can be extremely helpful to the staff in expediting and focusing its efforts in investigations regarding the accuracy of the financial statements and other disclosures contained in filings made with the Commission. The OCC examiners themselves are knowledgeable about the banks and their management and may have information or opinions which are not in writing but which may be helpful to the staff's efforts.

For the most part, the OCC has provided requested assistance. However, such assistance has at times been delayed or complicated, in part by the OCC's access procedures. The OCC has a multi-step access process. The OCC generally first requires the staff to request access to and then review on-site the ROSAs. The staff then almost always requests production of the entire document, both because at the early stage of an investigation the staff does not know the entire universe of what will ultimately prove relevant and because our investigative experience has borne out the importance of obtaining complete documents. After the staff's review of the ROSAs, the OCC typically requires another access request for additional documents and examiner interviews, in which the staff must specify the need for, and provide detail concerning, the areas of inquiry it wishes to pursue with examiners and with respect to additional documents. There is then further delay while the staff puts into writing its specification of the additional documents it wishes to obtain or the interest areas it intends to pursue with examiners, and waits for these requests to receive approval. The OCC often requires that subsequent requests for access to additional materials and OCC personnel follow this same procedure.

With respect to examiner interviews, the staff's experience has been mixed. In one interview, the staff reported that the OCC attorney would not permit the examiner to discuss matters not in writing nor to express opinions. In other interviews, the examiners have been permitted to speak without restrictions. Ready

access to examiners who are permitted to speak freely can educate our staff as to what materials may be most helpful, as well as provide other important information. It would substantially advance the staff's investigations if the OCC were willing to make its relevant files and personnel available at an early stage.3/

On the whole, our relationship with the OCC has evolved and improved over time. For example, with respect to access, while initially resistant to providing access to unredacted ROSAs and examination workpapers because of concerns that our access might have a chilling effect on the examination process, the OCC subsequently agreed to permit access.

In a variety of specific matters not primarily concerned with access issues, where the Enforcement Division and the OCC each had concerns arising out of the same events, many experiences have been quite positive.4/ Our agencies have referred to each other possible securities and bank regulatory matters and arranged for joint training programs in our areas of expertise. OCC and Commission staff have discussed instituting joint enforcement actions against certain entities. We expect that those efforts will soon result in the institution of joint enforcement actions. In addition, both the Commission and the OCC are members of the National Interagency Bank Fraud Working Group, and have worked together within that organization.

In sum, the staffs of the Commission and the OCC have recently taken a number of important steps toward better cooperation and coordination of regulatory and enforcement efforts involving bank securities activities. We expect to continue working cooperatively in the future, and hope that we will be able to use these new channels of communication to reduce regulatory burdens and to address the important investor protection issues that arise from bank involvement in the securities business.

* * *

3/ The general practice of the Commission's Enforcement Division when it receives access requests from other federal and state agencies is to grant access to the investigative files and then to make such files available to the requester for review.

4/ For example, in connection with the government sponsored enterprises portion of the government securities investigation, the SEC, the OCC and the FRB issued a joint order instituting administrative proceedings against, among others, approximately 30 national banks. The OCC, as the primary regulator of those banks, issued an administrative order sanctioning them, while the SEC and the FRB issued orders against other respondents.

Pursuant to Chairman Dingell's request, below are listed specific meetings that have taken place between Commission staff and staff of the banking regulatory agencies regarding examination and enforcement programs:

1. Aug. 4, 1993, 2:00 p.m., at SEC

Attendees: Chairman Levitt, Comptroller Ludwig

Topics: various issues, including coordination and cooperation between the SEC and the OCC

2. Aug. 13, 1993, 10:30 a.m., at SEC

Attendees: Chairman Levitt, Comptroller Ludwig

Topics: various issues, including coordination and cooperation between the SEC and the OCC

3. Sept. 8, 1993, Seminar Sponsored by OCC on Mutual Funds and Nondeposit Investment Products

Attendees: Bob Colby (SEC), Belinda Blaine (SEC), Chris Dear (SEC), Owen Carney (OCC), Rachel Romyn (OCC)

Topic: Training of OCC examiners on the federal securities laws, including the NASD Rules of Fair Practice

4. Oct. 26, 1993, Conference Call

Participants: Chris Dear (SEC), Bob Inskeep (OCC), Keith Larkin (OCC)

Topics: SEC broker-dealer examination program, including how firms are chosen to be examined, tools used in examinations, risk assessment, and monitoring broker-dealer firms in general

5. Nov. 5, 1993, 8:30 a.m., at OCC

Attendees: Chairman Levitt, Comptroller Ludwig, Simon Lorne (SEC), William Bowden (OCC), one or two additional staff members

Topics: relations between the SEC and the OCC, including enforcement matters, the Citibank matter, and the pending Chase Manhattan matter

6. Nov. 23, 1993, 12:00 p.m., at OCC

Attendees: Simon Lorne (SEC), William Bowden (OCC)

Topics: ways in which the SEC and OCC could better cooperate, including inspection of bank advisers

7. Dec. 13, 1993, 10:00 a.m., at SEC

Attendees: Barry Barbash (SEC), Barbara Green (SEC), Susan Woodward (SEC), Max Berueffy (SEC), William Dehnke (OCC), David Nebhut (OCC), Jan Poppalardo (FTC), John Rea (FRB), Stephen Weber (Market Facts, market researchers), Pamela Koger-Jesup (Market Facts), Amy O'Connell (moderator for focus groups)

Topics: focus group research about banks and mutual funds

8. Dec. 13, 1993, 2:00 p.m., at SEC

Attendees: Barry Barbash (SEC), Barbara Green (SEC), Thomas Harman (SEC), Richard Jackson (SEC), William Dehnke (OCC), David Nebhut (OCC), David Apgar (OCC)

Topics: mutual funds' use of bank names and banking agency's authority to regulate bank securities activities under safety and soundness doctrine

9. Dec. 20, 1993, 4:00 p.m., at SEC

Attendees: Chairman Levitt, Comptroller Ludwig, Barry Barbash (SEC), Colleen Mahoney (SEC)

Topics: bank mutual fund sales activities and Mellon/Dreyfus merger

10. Jan. 4, 1994, 10:00 a.m., at OCC

Attendees: Barry Barbash (SEC), Barbara Green (SEC), Thomas Harman (SEC), Ellen Broadman (OCC), William Bowden (OCC)

Topics: bank mutual fund sales generally, mutual fund investor focus groups, issues raised by Mellon/Dreyfus merger, functional regulation, OCC regulation and examination of bank securities activities, bank regulatory consolidation, OCC Banking Circular No. 274, mutual fund names, separation of banks' deposit and securities sales activities, disclosure issues, possibility of joint examinations, and SEC rulemaking proposals

11. Jan. 11, 1994, 2:00 p.m., at SEC

Attendees: Gene Gohlke (SEC), Richard Jackson (SEC), William Dehnke (OCC), Suzette Greco (OCC), Keith Larkin (OCC)

Topic: SEC investment company inspection procedures

12. Jan. 19, 1994, 10:00 a.m., at OCC

Attendees: Barry Barbash (SEC), Barbara Green (SEC), Susan Woodward (SEC), Catherine McGuire (SEC), Jan Poppalardo (FTC), David Apgar (OCC), Rachel Romyn (OCC), David Nebhut (OCC), John Rea (FRB), Stephen Weber (Market Facts), Pamela Koger-Jesup (Market Facts)

Topics: discussion of focus group research on bank sales of mutual funds, possibility of joint inspections, and development of OCC examination manual for securities sales activities

13. Feb. 22, 1994, 3:00 p.m., at SEC

Attendees: Barry Barbash (SEC), Barbara Green (SEC), Philip Parker (SEC), Robert Colby (SEC), Gene Gohlke (SEC), Robert Plaze (SEC), Belinda Blaine (SEC), Richard Jackson (SEC), Barry Mendelson (SEC), Katherine Horan (SEC), Ellen Broadman (OCC), Rachel Romyn (OCC), William Dehnke (OCC), Robyn Dennis (OTS), Dean Shahinian (OTS), Laurie Schaffer (FRB)

Topics: mutual fund disclosure, suitability requirements for sales of mutual funds, possibility of joint inspections, and banking regulators' guidelines regarding bank sales of mutual funds

There have also been a number of informal contacts (such as telephone conversations) that have taken place between various staff of the SEC and the OCC regarding examination matters.

The Enforcement Division has had extensive contacts with OCC personnel, both in meetings and by telephone, regarding specific investigations that are too numerous to list. Most recently, the major SEC participants involved in such contacts have been: Joseph Goldstein, Juan Marcelino, Thomas Lawson, Lani Lee, Susan Lebeaux, and Thomas Hamill.

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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April 4, 1994

ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, D.C. 20515-6116

Dear Mr. Chairman:

Enclosed is a chronology, prepared at my direction, responding to the question in your letter of March 11, 1994, about "SEC and OCC enforcement actions against Citibank." The enclosed chronology and supporting documentation include information that is nonpublic and extremely sensitive. We understand that, absent extraordinary circumstances, it is not the Subcommittee's practice to make public disclosure of nonpublic material without prior consultation with the Commission. We request that you follow this practice in this instance, and appreciate your concern for the confidential and extremely sensitive nature of this nonpublic information.

I would like to emphasize a few points about the enclosed chronology. The events described in the chronology occurred some time before Comptroller Ludwig and I took office. During our tenure, Comptroller Ludwig and I have tried hard to bridge the gaps that have in the past separated our two agencies. There remain fundamental philosophical and policy differences between the Commission and the OCC, but a number of important steps have been taken over the past year toward better communication and cooperation.

In the end, however, as I have repeatedly stated, personal relationships and goodwill cannot substitute for institutional relationships that are grounded in sound public policy and written into law. The problem of conflicting regulatory approaches to bank securities activities can be fully resolved only through the adoption of functional regulation legislation.

If you have any question about the enclosed materials, please contact me or William McLucas, Director of the Division of Enforcement.

Sincerely,

Arthur Levitt
Chairman

enclosures

Chronology of Contacts with the OCC Leading to the Commission's Enforcement Action against Citibank, N. A.

I. Chronology of certain of the contacts by the staff of the Commission's Division of Market Regulation with Citibank and the OCC leading to the January 1992 disclosure of resurfacing cancelled certificates.

Beginning in March, 1987, Citibank learned that the cancelled certificates 1/ that it was supposed to have previously destroyed, were reappearing in the market and causing losses to parties mistakenly honoring the certificates as legitimate. (Commission Order dated December 17, 1992 attached as Exhibit M; OCC Order dated June 25, 1992 attached as Exhibit K.) Citibank, however, failed to file timely Missing/Lost/ Stolen/Counterfeit Securities Reports on Form X-17F-1A ("Securities Reports") with the Securities Information Center ("SIC"), the Commission's designee for operating the Lost and Stolen Securities Program, as required by Section 17A of the Exchange Act and Rule 17Ad-12 thereunder. (Id.)

In the fall of 1990, certain of the cancelled certificates were recovered by the Secret Service as payment in an undercover drug sting operation. (Id.) The Secret Service advised Citibank and, on October 4, 1990, Citibank advised the FBI and OCC in a criminal referral that those particular securities had been lost or stolen. (Id.)

Subsequently, on October 25, 1991, Citibank notified the SIC as to every securities issue which it was aware at the time had been sent to MSM Corporation ("MSM"), the outside vendor that Citibank had retained to purportedly destroy the cancelled certificates. (Letter from Citibank to the SIC, dated October 25, 1991, attached as Exhibit A.) Thereafter, the SIC informed Market Regulation of the situation.

On November 22, 1991, Market Regulation contacted the head of Citibank's Investigations and Potential Loss Department, who "expressed apprehension about the potential dimensions of this matter." (Memorandum by Market Regulation, dated November 22, 1991, confirming conversation dated November 22, 1991, is attached as Exhibit B.) On November 25, 1991, Market Regulation again addressed the matter with Citibank, and in an electronic mail communication memorializing the conversation, Citibank's Senior Operations Head for Issuer Services wrote:

> [The] discussion [with the staff member] focused mainly on my trying to put the situation in proper perspective, fill in some missing details and assure

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1/ The face amount of the certificates was ultimately determined to be at least $111 billion.

> [the staff member] that this was not a current or ongoing problem... .

(Two Citibank electronic mail communications attached as Exhibit C.)

During the week of November 25, 1991, Market Regulation contacted the OCC and apprised them of the matter. Market Regulation suggested that the OCC, as the "appropriate regulatory agency" for Citibank, investigate the matter fully, ascertain the magnitude of the problem and determine whether additional notices should be made to protect the public.2/ Exhibit C memorializes the resulting telephone call to Citibank from the OCC as follows:

> On November 27, 1991, I received a call from [the OCC]. [He] had heard about this situation from the S.E.C. I provided [him] with a status. He was completely comfortable and indicated that Citibank did more than was necessary . . . [My] biggest concern is the S.E.C. and how to insure that [the Market Regulation staff member] doesn't broadcast Citibank's name in some manner.

On December 16, 1991, the OCC advised Market Regulation that the matter involved substantially fewer bond certificates than Market Regulation had been quoting. (Market Regulation Memorandum dated December 17, 1991, confirming conversation attached as Exhibit D.) Accordingly, on December 17, 1991, Market Regulation again contacted the head of Citibank's Investigations and Potential Loss Department to verify the number of cancelled certificates sent to MSM. (Id.) The head of Citibank's Investigations and Potential Loss Department

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2/ Because Citibank is a national bank, the OCC is "the appropriate regulatory agency" for Citibank pursuant to Section 17A(c)(3)(A) of the Exchange Act. Section 17A(d)(3)(A)(ii) states that the appropriate regulatory agency "shall assume primary responsibility to examine and enforce compliance by the transfer agent" with the relevant provisions. Section 17A(d)(3)(B) states that the Commission also retains authority to enforce compliance for violations of such provisions, stating, "Nothing in this ... title shall be construed to impair or limit ... the Commission's authority ... to enforce compliance pursuant to any provisions of this title by any ... transfer agent ... with the provision of this title... ."

reaffirmed the original numbers that Citibank had provided to Market Regulation. (Id.) 3/

On January 7, 1992, the OCC staff advised Market Regulation that "only 37 issues were involved and only a few hundred cartons of certificates." (Market Regulation memorandum dated January 7, 1992, confirming conversation attached as Exhibit F.) Market Regulation responded that the numbers were originally reported as 4,000 cartons and 817 CUSIPS. (The CUSIP shows the issue and issuer.) (Id.) Market Regulation was concerned whether appropriate disclosure had been made. The OCC staff member stated that he "has under study" whether Citibank should release a general notice. (Id.) The OCC staff advised Market Regulation that an OCC examiner was at Citibank working on the matter and that the examiner's report was due January 9. (Id.)

On January 9, 1992, Market Regulation called the OCC to determine the status of the OCC's oversight of the matter. (Market Regulation memorandum dated January 13, 1992, confirming conversation attached as Exhibit G.) Market Regulation provided the OCC staff with the 86 page document obtained from Citibank listing approximately 817 CUSIPS and many individual certificate numbers that were included in the approximately 4,000 cartons turned over to MSM and emphasized that the OCC staff should obtain more information from Citibank and encourage Citibank to disclose the matter publicly. (Id.) In response, the OCC staff advised Market Regulation that it disagreed with Market Regulation's interpretation of the Commission's rules governing the reporting of lost and stolen securities. (Id.) The OCC stated that they had advised its examiners of the matter and

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3/ A December 17, 1991 Citibank electronic mail communication memorialized a call from the OCC to Citibank as follows:

> I received a call yesterday from [an official with the OCC] Enforcement division in Washington. He informed me that [the Market Regulation staff member] has initiated a complaint with the OCC's Security Disclosure Division against Citibank. [The Market Regulation staff member] alleges "lack of cooperation" and "lack of full disclosure" concerning the MSM project... . [He] will suggest to [the Market Regulation staff] that any specific information that [the Market Regulation staff] requires be formally requested in writing.

(Citibank electronic mail communication, dated December 17, 1991, attached as Exhibit E.)

spoken with Citibank but that if the Commission staff wanted the OCC "to do more" it would "have to provide a formal referral in writing." (Id.)

On January 15, 1992, Market Regulation called the OCC to determine the status of the OCC's examination. (Market Regulation memorandum dated January 15, 1992, memorializing conversation attached as Exhibit H.) The OCC staff stated that there were "too many unanswered questions" at that time to formulate a reply. (Id.) The OCC informed Market Regulation that it was not until its January 9 conversation with Market Regulation described above that the OCC became aware that the OCC staff was the "appropriate regulatory agency" under the Exchange Act and that, until then, it had been their belief that the only matter that the OCC was expected to address was the staff's concern over whether Citibank cooperated with other regulatory and criminal authorities. (Id.) The OCC staff stated that "it now appreciates the scope of the matter... it has come to realize the size of the problem and will do everything it can to cooperate." (Id.)

On January 27, 1992, in another conversation between the staffs of the OCC and Market Regulation, the OCC stated that it had no additional information about the matter since the last conversation. (Market Regulation Memorandum dated January 27, 1992, confirming conversation attached as Exhibit I.) On January 28, 1992, Market Regulation informed the OCC staff that, in view of the fact that adequate notice still had not been provided to the market, Market Regulation intended to request that the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") issue warnings to their members concerning the resurfacing of the cancelled certificates. Market Regulation made that request on January 28, 1992, and the NYSE and the NASD issued their warnings.

On January 29, 1992, Citibank issued a press release disclosing that cancelled bonds were being presented and that financial intermediaries should take precautions with presentations. (Citibank press release dated January 29, 1992, attached as Exhibit J.) Also on January 29, 1992, the OCC issued a bulletin warning its member banks of the problem.

II. Chronology of certain of the contacts by the staff of the Commission's Division of Enforcement with the OCC prior to the Commission's enforcement action.

During May 1992, after the Enforcement staff had completed its investigation, the Enforcement staff notified the OCC staff that the Enforcement staff intended to recommend to the Commission an action against Citibank and proposed that the two agencies proceed jointly or at least coordinate the institution of separate agency actions. (Correspondence between the OCC and

the staff attached as Exhibit K.) 4/ On June 8, 1992, the OCC provided the Enforcement staff with the OCC's draft order against Citibank, requesting the staff's comments by three days later, on June 11. (Id.) On June 17, the staff advised the OCC that the staff was not prepared at that time to respond with specific comments on the OCC's draft order and the staff continued to urge the OCC to consider a joint administrative effort. (Id.) The OCC, by letter of June 17, again requested the staff's comments on the OCC's draft order, this time by two days later, on June 19. (Id.)

By letter of June 23, the Enforcement staff reiterated its intent to recommend an action against Citibank to the Commission and pointed out several concerns about the OCC's action and again urged the OCC to proceed jointly. (Id.) On the evening of June 24, the OCC advised the staff that the OCC was issuing its order the following morning. (OCC Order against Citibank dated June 25, 1992 attached as Exhibit L.)

Thereafter, at the time that the Enforcement staff recommended to the Commission that it commence enforcement proceedings against Citibank, the OCC submitted a letter to the Commission, dated July 23, 1992, arguing that the Commission should not proceed with any action against Citibank because it would be duplicative of the OCC's action. (OCC letter dated July 23, 1992 to the Commission attached as Exhibit M.) The staff, however, believed that the Commission action and remedies would not be duplicative of the OCC action and recommended to the Commission that it proceed with an action.

On December 17, 1992, the Commission filed a complaint for a civil money penalty in the U. S. District Court. Without admitting or denying the allegations, Citibank consented to the entry of a penalty of $750,000 based on its failure to file timely Securities Reports from the October 15, 1990 effective date of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. Citibank also consented to the Commission Order that Citibank permanently cease and desist from committing or causing any violations in the future of the reporting and safeguarding requirements for transfer agents. (Commission Litigation Release, Complaint and Order dated December 17, 1992 attached as Exhibit N.)

4/ The Enforcement staff provided its complete investigative record, including the transcripts of the testimony of witnesses, to the OCC. The OCC, however, withheld their notes of interviews of witnesses, claiming the attorney-workproduct doctrine and, instead, provided the staff with summaries of their interviews.

EXHIBITS

A	Citibank letter to SIC dated October 25, 1991
B	Market Regulation memorandum dated November 22, 1991
C	Citibank electronic mail communications
D	Market Regulation memorandum dated December 17, 1991
E	Citibank electronic mail communication dated December 17, 1991
F	Market Regulation memorandum dated January 7, 1992
G	Market Regulation memorandum dated January 13, 1992
H	Market Regulation memorandum dated January 15, 1992
I	Market Regulation memorandum dated January 27, 1992
J	Citibank press release dated January 29, 1992
K	Correspondence between the OCC and Enforcement staff
L	OCC Order dated June 25, 1992
M	OCC letter dated July 23, 1992
N	Commission actions dated December 17, 1992

EXHIBIT A

CITICORP CITIBANK

k, N.A.
diary of
D
ll Street
ork, NY

Clifford A. Kendelhardt
Vice President

Ms. Cindy Marcoaldi
Securities Information Center, Inc.
Post Office Box 421
Wellesley Hills, Massachusetts 02181

October 25, 1991

Re: Generic Message

Dear Ms. Marcoaldi:

As you and I have discussed in the past, we would like to take advantage of your ability to attach a message to a CUSIP rather then putting stops on a large volume of certificates.

The message is to be used exclusively on Bond issues that have matured or have been fully called. What I am proposing to expedite this process is that I provide you with a list of the CUSIP's involved and that you act based upon that list and my authorization. The exact message that we ask you to use is:

> This Issue has matured or is fully called.
> Contact Citibank, N.A. at 1-800-422-2066
> prior to executing any transaction.

Some time in the future I will again be in touch with you as we continue to investigate this problem and try to find workable solutions to it. A report on this matter has been filed with law enforcement agencies. Those Agencies are actively working on this investigation with representatives from our internal Audit Division.

Should you have any difficulty in implementing this request, please do not hesitate to contact me at 212-657-7422 immediately. I will be glad to assist you in any way that I possibly can. Our FINS/SIC Identifcation Number is 209080 and my access code is 09F.

Very truly yours,

CAK/ct

Enclosures

EXHIBIT B

November 22, 1991

TO: Jonathan Kallman
Ester Saverson

FROM: Tom Etter

RE: $3 million of
lost certificates

SIC

John Boehmke of SIC told me that he has a list from Citicorp of the missing securities by CUSIP number. They total 428 CUSIPS (with at least two duplicates). On October 28, 1991, SIC put the CUSIPS on-line in the system in the Counterfeit File. The certificates themselves are not on the system. The theory is that the CUSIPS being on the system will flag the entries. So far, there have been a few hits but no pattern.

Later today (as I reported to Ester) Boehmke phoned back to say that Citicorp and Chase had just phoned him saying that their attorneys had advised that using just CUSIPS was not good enough and that the banks must file individual Form X-17fs for each certificate. Boehmke would like an answer from us as to whether all of these forms should be added to the system or whether he should ship them back as they come in. I told John that we would get back to him as quickly as we could.

Citicorp

The Citicorp contact person for this matter is Arthur Lloyd, VP, Internal Auditing Group (212/559-2500). Lloyd is an attorney who heads the Department of Investigation and Potential Loss (focusing on loss by operations and fraud). Lloyd said that, while he has been working on the $3 million loss of bonds, a new batch of $30 million face amount of bonds turned up yesterday in Amsterdam at the ABN Amero (Amsterdam-Rotterdam) Bank, and that some certificates came from his bank and some from Irving Trust. Both groups come from the same source. The $3 million and $30 million groups together, he said, total 817 CUSIPS. He had no further breakdown, but noted that Don Schneider of the Bank's Corporate Trust unit (212/657-7863) could provide us the CUSIPs for the two missing groups, adding that Schneider's office has a fairly complete computerized mapping of the matter and could provide further detail. Schneider, however, was away from the office when Lloyd and I tried to reach him.

Lloyd expressed apprehension about the potential dimensions of this matter. Both batches come from a 1987 shipment of 4,000 boxes of cancelled certificates sent by Citicorp (not counting other banks) to a company called MSM for destruction. Some of these "destroyed" certificates are now appearing and he has no idea of the size of the problem.

As requested, I asked Lloyd to fax us: (1) a CUSIP list of the missing securities (the $3 million and the $30 million groups) and as much other description as is possible; (2) a CUSIP list of the potential lost securities; and (3) a CUSIP list of all the securities they were dealing in. Lloyd said he will get together with Corporate Trust and see what can be done.

DTC

I phoned Larry Thompson (212/898-3240) and Dennis Dirks (212/898-3700) and spoke with Dennis who said DTC has issued a notice of the securities and that Richard Nesson has faxed us a copy. I checked with Esther Forster (while Dennis was holding) and told Dennis that as of 4 p.m. we have not received it. He promised to see Nesson and make sure it is faxed today.

HE DEPOSITORY TRUST COMPANY

IMPORTANT

B# 10,271-91

DATE: November 22, 1991

TO: All Participants, Depository Facilities, and Pledgee Banks

ATTENTION: Managing Partner/Officer/Cashier

SUBJECT: SPECIAL ALERT TO PARTICIPANTS
Deposits of Previously Cancelled Securities

DTC has recently encountered several instances where deposited certificates, upon presentation for transfer into DTC's nominee name, Cede & Co., have been confiscated by the transfer agent because the certificates were previously cancelled on the records of the agent. In each instance, DTC processed an adjustment to reduce the depositing Participant's account in accordance with applicable DTC procedures.

It is unclear how many previously cancelled certificates are being presented as valid for sale to DTC Participants and other financial intermediaries. There are reports that issues transferred by several transfer agents may be involved.

DTC has received information that this matter may involve certificates of different issues which were cancelled some years ago. It appears that an unknown but potentially large number of cancelled certificates that had been earmarked for destruction may now be in circulation and may stem from foreign sources.

DTC has been advised that the cancelled certificates may have been perforated with holes signifying their cancellation which may not be readily apparent. The perforations may be located on the bottom portion of the certificates. DTC has also learned that this matter is being investigated by appropriate legal authorities.

Participants are advised to take whatever action or precautions they deem necessary and to comply with applicable industry practice and rules, if any, respecting the need for them to advise other financial intermediaries of this information.

If you have questions regarding this notice or need additional information, please contact your Participant Services representative.

Dennis Dirks
Senior Vice President
Operations

EXHIBIT C

To: David Boyle (USNYC:IFI)
CC: Arthur G.Lloyd (USNYC:AUD), Raymond A.Parodi (USNYC:IFI),
CC: Caroline Marks (USNYC:IFI), Edward J. Kowalcyk (USNYC:AUD),
CC: Anne Luzzatto (USNYC:CORPAFF)
From: Don Schneider (USNYC:IFI)
Subject: CANCELLED SECURITIES/MSM CORP.

The purpose of this Citimail is to update you with respect to development of the past week involving Depositary Trust Company, Securities and Exchange Commission and Office Comptroller of the Currency.

On November 22, 1991, Dennis Dirks, SVP. of DTC called to indicate he had heard of this problem and felt that DTC needed to advise its participants. We discussed this situation briefly. I advised Dennis that securities from issues where Chase and BONY acted as trustees had surfaced as well, and that Citibank did not want its name mentioned in any DTC notice.

On the same date DTC distributed a general notice to the effect that there were reports that previously cancelled securities had surfaced in the market place and that all participants should examine certificates
** Type return to continue **, F to finish:
more carefully. Participants were advised to contact the named transfer agent or trustee of any particular issue that involved previously cancelled securities. DTC also notified the Midwest and Philadelphia depositaries and will notify Cedel and Euroclear.

On November 25, 1991 I spoke with Ester Saverson at the S.E.C. after he reached you and was referred to me for details. Mr. Saverson indicated that he believed Citibank was in violation of Reg. 240.17F-1 relating to the reporting of lost and stolen securities. I indicated that we disagreed, the system was not intended for this situation, that the reporting bureau indicated the same and that Citibank was doing more than was required by filing with the reporting bureau. It was obvious from Saverson's tone that he does not care in the least about the impact of any negative publicity upon Citibank.

Mr. Saverson learned about our dilemma from the reporting bureau when we contacted them to discuss the manner in which we could report our data to them. He came to the conversation armed with most of the facts about the situation and our discussion focused mainly on my trying to put the situation in proper perspective, fill in some missing details and assure Mr. Saverson that this was not a current or ongoing problem.

Reg. 240.17F-1 has been referred to Carrie Marks in the event the S.E.C.
** Type return to continue **, F to finish:
revisits its interpretation and attempts to invoke sanctions.

I am sure we will have a continuing dialogue with the S.E.C. as they are into the minutiae vs. the broad perspective.

On November 27, 1991 I received a call from George Sidterly, Chief Trust Examiner for the Office of the Comptroller of the Currency. George had heard about this situation from the S.E.C. I provided George with a status. He was completely comfortable and indicated that Citibank did more than was necessary.

By biggest concern is the S.E.C. and how to insure that Mr. Saverson doesn't broadcast Citibank's name in some manner.

Don

read

To: Ron J. Warmington (EULON:AUD)
CC: Don Schneider (USNYC:IFI), Edward J. Kowalcyk (USNYC:AUD)
From: Arthur G.Lloyd (USNYC:AUD)
Subject: Non-destroyed Cancelled Securities

Ron,

Don Schneider has been contacted by a representative of the Securities and Exchange Commission (SEC), who contends that Citibank had an obligation to report the loss of the subject securities under Rule 17-f. Citibank has maintained from the outset that the bonds in question are not "live" securities, and as such, need not be reported. Nevertheless, out of an abundance of caution, Citibank has been in contact with the SIC (the computer information center in Waltham, Massachusetts) and is acting in a spirit of full cooperation.

The SEC man, Mr. Saverson, does not seem satisfied with Citibank's efforts, and has suggested that further notifications be given, not only in the U.S., but also in Europe, through EUROCLEAR and CEDEL. I told Don that IPL had notified IBSA, which had the effect of alerting Interpol, but that I did not know if Interpol, in turn, would have notified the European clearing
** Type return to continue **, F to finish:
agencies.

Our friend Jerry Bouman of ABN-Amro Bank is one of IBSA's Interpol representatives. Please ring him as soon as possible and try to get an answer to me via phone or Citimail. A copy to Don Schneider would be appreciated.

Regards,

Art

Command: send ack
CMNA 25-NOV-91 21:30:59 007038
Message sent.
Command:

EXHIBIT D

December 17, 1991

TO: Jonathan Kallman
Ester Saverson

FROM: Tom Etter

RE: Cancelled Certificate Scam

As requested, I phoned Arthur Lloyd of Citibank. Lloyd is VP, Office of Investigation and Potential Loss. He was joined by his assistant, Bill Reidy. I mentioned that, concerning Citibank's exposure, John Shockey of OCC had told us yesterday that the original numbers given to us of 4,000 Citibank cartons and 817 CUSIPS were wrong and that there actually were only 500 cartons and about 44 CUSIPS. Lloyd and Reidy said that OCC is incorrect and that those new numbers did not came from their office. The correct numbers, they said, are 4,000 cartons and approximately 817 CUSIPS, of which about 300 CUSIPS are active.

I asked about notification by Citibank of the scam to the industry, noting that Shockey had suggested that we contact Arthur Lloyd about the matter. They told me that this is wrong and that the people to contact are Don Schneider, Chris Kendlehart, and their staff in Citibank's Corporate Trust Department. Lloyd said that his office has played only a minor role in the matter, and that it is being handled by Corporate Trust, which is a line department of the bank.

I asked them anyway what notices Citibank had issued, inasmuch as OCC had recommended asking them. They replied that a notice of the scam was sent last July 1991 to the International Bank Securities Association, which consists of 65 banks. (They are sending us a copy of the notice.) I asked if there has been any thought of noticing the entire banking and brokerage communities or at least the firms where Citibank has a business relationship. They had no direct response and merely emphasized at some length how cooperative Citibank is being, how effective its notice program has been, how arrests are being made every day, et cetera. In general, however, their knowledge of the matter seemed to me more anecdotal than comprehensive.

Bill Reidy volunteered to put together a chronology of what Citibank, or at least his office, has done to date concerning the scam and fax it to us.

2

EXHIBIT E

CMNA 18-DEC-91 21:30:36 004019

To: Caroline Marks (USNYC:IFI)
CC: Don Schneider (USNYC:IFI)
From: Clifford Kendelhardt (USNYC:INV)
Date: WED 18-DEC-91 21:30 GMT

Caroline,

Attached please find the Citimail that you and I have just discussed!

Please keep us advised of what you are able to find out.

regards

Cliff

Forwarded message:

CMNA 17-DEC-91 13:28:51 000595

To: Raymond A.Parodi (USNYC:IFI), Arthur G.Lloyd (USNYC:AUD),
To: Don Schneider (USNYC:IFI), David Boyle (USNYC:IFI),
To: Clifford Kendelhardt (USNYC:INV), Robert A. Harris (USNYC:IFI)
From: William N. Reidy (USNYC:AUD)
** Type return to continue **, F to finish:
Date: TUE 17-DEC-91 13:28 GMT
Subject: MSM Securities Case

I received a call yesterday from John Shockey, Office of the Comptroller of the Currency, Enforcement Division in Washington. John has been a good friend of IPL for many years and has worked closely with many members of this unit, primarily in the area of identifying potential scams.

He informed me that a Mr. Saverson, who some may know is an Attorney with the S.E.C. has initiated a complaint with the OCC's Security Disclosure Division against Citibank. Mr. Saverson alleges "lack of cooperation" and "lack of full disclosure" concerning the MSM project. When pressed for specifics by John Shockey, Saverson only mentioned that he had requested a listing of all issues involved in this matter with the associated CUSIP numbers. I checked with Cliff Kendlehardt who informed me that a full list had been FAXED to Saverson on or about 12/1/91 (80 pages). This was related to John Shockey, who ws was to call Saverson late yesterday afternoon.

John Shockey will suggest to Saverson that any specific information that he requires be formally requested in writing. We are aware of no such
** Type return to continue **, F to finish:
requests at this time.

I will keep you informed as things develop.

Delivered: WED 18-DEC-1991 21:30 GMT

EXHIBIT F

January 7, 1992

TO: Jonathan Kallman

FROM: Ester Saverson
Tom Etter

RE: Update on Citibank Scam

Over the past two weeks, we generally have had difficulty making useful contacts due to the holidays.

On January 3, Andy Massa, President of STA, told us that the STA Operations Committee meeting in NYC on December 11, 1991, where he had hoped to discuss this matter and solicit ideas about cancellation practices, turned into a Christmas party and no work got done. He asked that we give STA and its Operations Committee another week or two to develop its position on this matter.

On January 3, American General Co. of Houston, which acts as its own transfer agent, phoned to report that its cancelled stock certificates, from the period when Citibank was its predecessor transfer agent, are coming back. This marks the first time we have heard of stocks being involved.

On January 6, we alerted the DRO-Enforcement (Larry Christ) regarding the recent phone calls about this scam from Richard Moore of Paulson Investment Services of Colorado (apparently an unregistered broker-dealer) to Citibank, SEC, and others. DRO will check out the people involved. We emphasized that no actual contact should be made at this point.

REDACTED

(Discusses an FBI investigation
and identifies an individual.)

On January 7, Merrill Lynch of New York informed us that on January 6 it received some cancelled bond certificates that were offered as margin account collateral in its Berlin office. Merrill's corporate security and compliance offices have collected over $2 million of the certificates in recent months. They expressed concern that people are slipping them into the firm's European margin accounts. While they are confident about catching the six-figure certificates, they doubt they can catch all the smaller ones. Two certificate related arrests were made in Merrill's Berlin office over the past month, but the police

found the suspects to be just innocent middlemen. Merrill's security people said the certificates looked as good as new except for some perforations along one edge, and that nobody would know they were cancelled. They recommended that the Government require cancelled certificates to be marked "cancelled." They also reported Street talk that a discounted "black market" for the bonds has developed in Europe and that the certificates are being housed in one or two major vaults in Geneva or Berlin.

On January 7, we talked with Bill Granovsky of OCC. He said OCC has an examiner in the field working on the Citibank matter but that the examiner hasn't reported in yet and is not due back until Thursday, January 9. Granovsky noted that only 37 issues were involved and only a few hundred cartons of certificates. We noted that the original numbers reported to us were 4,000 cartons of certificates and 817 CUSIPS, which we since have re-confirmed with both Don Schneider, VP, Corporate Trust Department and with Arthur Lloyd, VP, Internal Auditing Group. Granovsky said he didn't know where his information came from. He added that he has "under study whether or not a notice should go out to be aware of bond certificates." He agreed to phone us when the examiner comes back.

EXHIBIT G

January 13, 1992

TO: Jonathan Kallman

FROM: Ester Saverson
Tom Etter

RE: Citibank scam

At about 4 p.m., Thursday, January 9, 1991, we phoned Don Lamson and Bill Granovsky of the Office of the Comptroller of the Currency. OCC had an examiner at Citibank over the previous week or two, and he reported back on January 9.

OCC began by telling us that they would like to resolve all the issues here one by one. They said to the extent any problem has existed about Citibank's not cooperating with the FBI, it is OCC's "understanding" that the matter has been completely resolved. OCC added, however, that they have not talked with the FBI, only with Citibank. We made no comment.

Concerning the cancelled bond certificates, OCC said it is their "understanding" that the problem has been "greatly downsized" and that only about "38 issues have come up." We asked on what basis the numbers were downsized, and OCC said it didn't know. We asked who they were talking with at Citibank, and we were told Bill Reidy. We noted that we have confirmed the numbers of 4,000 cartons of certificates and 817 CUSIPS with several people at Citibank, including Bill Reidy. OCC claimed that their information on the numbers was more current than ours and that SEC has become confused by talking with too many people at Citibank. We read aloud to OCC our memo dated December 17, 1991, where at the express suggestion of John Shockey of OCC we verified the numbers with Bill Reidy of Citibank and his boss Arthur Lloyd. We noted that we have not contacted Citibank since that time because we believed that OCC was handling the matter.

We noted too that we have an 86 page list from Citibank of the 817 known CUSIPS that were included in the 4,000 cartons shipped by Citibank to MSM Corporation for destruction, and that the list is incomplete. OCC indicated that it didn't know such a list existed and asked us for a copy, which we agreed to provide. In any case, OCC apparently has chosen to limit the universe of the scam's bond issues to those that have fraudulently surfaced to date, rather than dealing with the bond issues that are known to have been included in the shipments to MSM Corporation, many of which have years to run until maturity and/or have active CUSIPS and can surface at any time.

We said that under the rules governing the Lost and Stolen Securities Program, the missing securities must be reported to SIC. OCC replied that they disagree with our interpretation of the rules. We reminded OCC that they are SEC rules.

We noted that under the 34 Act, OCC has primary responsibility in this area with regard to Citibank. OCC said it knows this and that it has advised its examiners of the scam and has talked with Citibank about the matter, largely as a courtesy to the SEC. They added that if SEC wants OCC to do more it will have to provide a formal referral in writing. We replied that we personally have no authority to do so, and that a referral probably would require approval from our Division director or from the Commission.

OCC assumed a tone of cross-examination and asked exactly what information SEC wants from Citibank. We replied that, first, we would like a complete list of the securities involved because the existing 86 page list has many of the CUSIPS marked as "unknown."

We said that, second, we would like to be sure that Citibank is getting the word out about this scam. OCC replied that it is their "understanding" that Citibank already has gotten the word out and that notices have been circulated to various depositories around the world. We asked if OCC had any copies of notices that Citibank had sent out, and they said they did not. We asked if they would ask Citibank to fax us copies of any notices that it has sent out, and OCC declined to do so.

OCC asked us who else, exactly, we would like Citibank to notify. We replied that the overseas depositories were notified by DTC, not by Citibank. And because we had no information on who, if anyone, Citibank had notified, we were in no position to offer advice on who else Citibank should notify. We added that we are concerned that the notices that have gone to major institutions may not trickle down to the smaller banks and brokers in North America and Europe and that we would welcome a notification by Citibank, at a minimum, to the NASD and to the ABA. We also recommended that Citibank provide notice to other geographic areas with sophisticated markets such as Japan and Australia. OCC seemed to be in agreement on these points, but it made no promises.

OCC asked us exactly what Citibank should say in such a notice. We read them the text from our December 16, 1991 memo (p. 5, para. 4) recommending that such a notice include: (1) a profile of the bond certificates (that they are U.S. corporates, dates of issue, cancellation, and maturity, etc.), (2) a description of Citibank's cancellation markings on the certificates, and (3) a warning that the bonds are being used for loan collateral and for deposits in custodial accounts in addition to being offered for sale. OCC seemed most surprised that we had such a definitive answer ready, and they indicated that they were taking down the information.

The conversation ended by our confirming that we would send OCC a copy of Citibank's 86 page list of missing bond certificates.

EXHIBIT H

January 15, 1992

TO: Jonathan Kallman

FROM: Ester Saverson
Tom Etter

RE: Citibank Scam - Telephone conversation with OCC

At 2;00 p.m. today, we (Julio Mojica, John Greely, Ester Saverson, and Tom Etter) placed a pre-arranged conference call to the Office of the Comptroller of the Currency where we spoke with Bill Granovsky, Don Lamson, [redacted], and Jim McDonald. Jim McDonald was said to be from the "supervisory side" with examination authority over Citibank.

We asked OCC what it had found at Citibank concerning the so-called cancelled certificates for the 817 CUSIP numbers. OCC stated that there are "too many unanswered questions" at this time for them to formulate a reply.

We asked about the examiner that OCC keeps on-site at Citibank and what he knows about the certificate scam. OCC replied that their man on-site is a generalist and knows nothing about it.

We asked, from an inspection viewpoint, what OCC has been doing in recent months in connection with this potentially explosive situation. OCC (Lamson) replied that OCC never knew that OCC was the appropriate regulatory agency for this matter until the telephone conversation it had last Thursday, January 9 with Ester Saverson and Tom Etter. Until then, OCC said it had been their belief that the only matter that OCC was expected to address was the concern over whether Citibank was cooperating with DTC, FBI, and SEC. OCC also said that it realized SEC had an interest in the case and that it didn't want to interfere.

OCC added that it now appreciates the scope of the matter, noting that "$800 billion is big numbers," and that it is "taking steps." [Note: The "$800 billion" figure, which Citibank developed for the FBI, is Citibank's confidential estimate of its potential exposure from this scam.] OCC said that after the January 9 telephone conversation with SEC and after having received from SEC the 86 page list of Citibank securities involved, it has come to realize the size of the problem and will do everything it can to cooperate.

We suggested that OCC may want to encourage Citibank to work with DTC and to provide DTC with the missing CUSIPS. In reply, OCC (Lamson) indicated that OCC would look into doing so.

We suggested that OCC encourage Citibank to provide appropriate notices of the scam to the financial community. In reply, OCC asked us if the information could be circulated by DTC. We replied that: (1) DTC doesn't have all the CUSIPS and that it can get the missing CUSIPS only from Citibank, and (2) DTC cannot release any specific information about the securities unless authorized to do so by Citibank, and (3) Citibank is in the best position, in terms of having the information readily available, to prepare an appropriate notice. OCC (Lamson) stated that it is concerned about the notice, but it wants to break down the matter into steps and take them one at a time.

OCC asked if we had any further comments. We noted that we have been asked how high the information on this situation has gone at Citibank and whether it has gone up to the General Counsel or to the Office of the President. OCC said it didn't know and that it hopes to learn the answer very soon.

We emphasized that we are concerned about getting the information on this scam to the smaller banks and brokers, noting that if down the road financial institutions start failing because they accepted these certificates as collateral, whether they are OCC banks or not, the situation will be impossible for anyone to explain either to the Commissioners of the SEC or to Congress. OCC concurred in these comments.

OCC indicated that they expect to have more information in a week or two and will get back to us.

At that point the conference call was terminated.

cc: Julio Mojica
John Greely

EXHIBIT I

January 27, 1992

TO: Jonathan Kallman
Ester Saverson

FROM: Tom Etter

RE: Conference call with OCC
about Citibank scam

At 10:45 a.m. today, we (Julio Mojica [on the line from New York], John Greely, and Tom Etter) placed a pre-arranged conference call to the Office of the Comptroller of the Currency where we spoke with Don Lamson and Bill Granovsky.

We requested an update on what has happened since we last talked with them on Wednesday, January 15, 1992. OCC (Lamson) replied that it has no additional information about the scam or about Citibank's actions in response to the scam. OCC added, however, that they (Lamson and others) will be going to Citibank this Thursday-Friday, January 30-31 and that they will have more to say after that visit.

In response to our previous question of how high in Citibank's management the information on this matter has gone, OCC told us that its Examiner-in-Chief at Citibank has informed Citibank's General Counsel, Jack Roach, of the scam. We asked if the scam were news to Roach or whether he already knew, but OCC stated it had no information on that point.

We asked if Citibank has turned over a complete list of the involved CUSIPS to DTC. OCC replied that Citibank claims that it gave all the CUSIPS to DTC long ago. We asked OCC if it has a list of what Citibank gave DTC, and OCC said that they have only the 86 page list that they were given by the SEC.

We asked if Citibank has put out any notices of the certificate scam to the financial community. OCC replied that Citibank may have put out some notices. We requested copies of any notices that Citibank may have put out.

We told Citibank that we have six so-called cancelled Georgia Pacific bond certificates, having a face value of $431,000, that emanate from the Citibank shipments of certificates to MSM Corporation. We said that none of these certificates bear any cancellation marks whatever, that they are in perfect condition, and that they are part of an $8 million batch of 400 similar certificates captured in a Secret Service sting operation. We noted that this incident is causing us to wonder what sort of safeguards Citibank has been using in its certificate cancellation practices.

OCC replied that Citibank is improving its cancellation practices. OCC asked us for xerox copies of the certificates, which we said we would have ready for their messenger pickup at 2:00 p.m. today.

We asked OCC when they might be able to let us know more about the Citibank situation. It was agreed that OCC will call us on Monday, February 3 at 4:00 p.m.

Once again, it was emphasized to OCC that we are facing a potentially explosive situation. We noted that if financial institutions begin failing because they accepted this worthless paper as collateral, our two agencies will never to able to explain to Congress how we knew of this matter since October 1991 but did absolutely nothing about it.

* * * * *

Following the phone call, in a brief discussion among ourselves, the question was raised concerning what we should do in view of the fact that: (1) OCC has primary regulatory authority here, and (2) OCC has known about the Citibank situation for months and simply has turned a blind eye to it and reacted with surprise to whatever information we provide them on the subject.

It was suggested that we could do nothing in the form of intervening (even if we wanted to) before Monday, February 3 when OCC is due to report back. It was thought that at some point it may be necessary for the SEC to contact senior people at OCC and/or Citibank. Julio said that we are in an uncomfortable situation and the Director is in Europe. Julio told us to meet with Mark Fitterman and Jonathan Kallman today and to make sure they are fully informed.

cc: Mark Fitterman
Julio Mojica
John Greely

January 27, 1992

TO: Files

FROM: TCE

RE: Citibank Scam

Subject: Points to be broght up in conference call with OCC

1. From an inspections viewpoint, what has OCC been doing concerning this scam?

2. What is going on at Citibank?

3. Who at Citibank, at its higher levels, knows of the scam and the potential risks to Citibank and the marketplace? What information has gone to the General Counsel? The Office of the President?

4. Is OCC aware that we have received in hand some of the so-cancelled certificates and that they are in mint condition with no cancellation marks whatever?

5. What has Citibank done about getting out a precise notice of the certificates involved? Has Citibank noticed the International Securities Market Association as requested by Euro-clear and Cedel?

6. If Citibank has sent out any notices, may we have copies?

7. What action is OCC recommending Citibank to take regarding this scam?

8. So far, it appears that Citibank is simply letting events take their course. Is this an accurate observation?

EXHIBIT J

CITICORP CITIBANK

Public Affairs Division

Citibank, N.A.
399 Park Avenue
New York, N.Y.
10043

Contact: Anne Luzzatto
(212) 559-4391

For Immediate Release

New York, January 29, 1992. Citibank said today that several banks, including Citibank, have become aware that a number of bonds are appearing in the market which had been canceled in 1986 and before. These perforated bonds are being fraudulently presented in the United States and Europe.

Citibank has been working with law enforcement agencies which are investigating these fraudulent presentations. The Securities Information Center, the Depository Trust Company, the NASD, the New York Stock Exchange and others have been notified.

Citibank is continuing to work with the Depository Trust Company to disseminate more detailed notice and to remind any financial intermediaries to take all appropriate precautions, especially when presentations are made by unfamiliar parties. Said a Citibank spokesperson, "While we believe we have no exposure, and that all normal channels of industry notice have been used, recent activity has led us to issue this statement."

EXHIBIT K

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

June 8, 1992 BY FAX

Joseph Goldstein
Associate Director
Division of Enforcement
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Citibank, N.A. ("Bank")

Dear Mr. Goldstein:

This will confirm our telephone conversation of this date concerning the above-captioned bank. I have enclosed with this letter a copy of the draft order the staff proposes to issue in connection with the institution of proceedings under authority of section 17A of the Securities Exchange Act of 1934 ("Exchange Act"). The OCC would impose a censure and remedial sanctions after finding that the Bank had engaged in numerous violations of the Exchange Act and Securities and Exchange Commission rules governing transfer agent activities.

The staff would appreciate your comments concerning the proposed remedial measures contained in the proposed order. If you or your staff could provide your comments by Thursday, June 11, we can ensure that they will be taken into account in a final draft, should the Office decide to bring an action as the staff has proposed. Thank you in advance for your help in this matter.

Should you or the SEC staff have any questions concerning this matter, please contact the undersigned at (202) 874-5210.

Very truly yours,

Donald N. Lamson

Donald N. Lamson
Assistant Director
Securities & Corporate
Practices Division

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

June 17, 1992 BY TELEFAX

Joseph Goldstein
Associate Director
Division of Enforcement
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Citibank, N.A. ("Bank")

Dear Mr. Goldstein:

This will confirm my telephone conversation of this date with Ms. Lani Lee, Branch Chief, of your office concerning the above-captioned bank. In that conversation, Ms. Lee stated that the staff of the Division of Enforcement was not prepared to make any comments concerning the June 8 draft order the OCC staff proposed to issue in connection with the institution of proceedings under authority of section 17A of the Securities Exchange Act of 1934 ("Exchange Act"). In that order, the OCC, as the appropriate regulatory agency, would impose a censure and remedial sanctions after finding that the Bank had engaged in numerous violations of the Exchange Act and Securities and Exchange Commission rules governing transfer agent activities. As I discussed with Ms. Lee as part of our effort to consult on this matter, the OCC yesterday informed the Bank's board of directors that it intends to bring such an action and has begun negotiations to resolve the matter consensually.

As I informed you and your staff during a May 14 meeting in your office, the OCC staff had determined to recommend to the Comptroller the initiation of this administrative enforcement action. You informed me during that meeting that the staff of the Division of Enforcement was contemplating recommending to the SEC a substantially similar administrative enforcement action seeking similar relief. I expressed our staff's view that the OCC, as the appropriate regulatory agency for national banks registered as transfer agents, rather than the SEC, is the appropriate agency to bring an administrative enforcement against national banks generally, and the Bank in particular, to remedy violations of transfer agent rules. Because the OCC has acted to address the Bank's violations of law in a manner that is virtually identical to

that contemplated by the SEC staff, we encouraged the SEC not to exercise any residual authority it may have to address this same conduct through duplicative administrative enforcement action. I also stated that, as part of the consultative process required by the Exchange Act and in order to ensure regulatory consistency, the OCC staff would welcome the views of the SEC in fashioning appropriate relief against the Bank. It was for that reason that the OCC staff on June 8 transmitted the draft order against the Bank for comment by your staff.

I confirmed in my conversation of this date with Ms. Lee the OCC staff's view expressed during our May 14 meeting with the Division of Enforcement that the OCC, as the appropriate regulatory agency, rather than the SEC is the appropriate agency to bring an administrative enforcement against the Bank in this case. I offered to provide Ms. Lee relevant legislative history that addresses this jurisdictional question directly and she requested that I send her by telefax references to this material today. Accordingly, I have attached a list of legislative source materials that address this jurisdictional question.

The staff would continue to appreciate your comments concerning the proposed remedial measures contained in the proposed order. If you or your staff could provide your comments by Friday, June 19, we can ensure that they will be taken into account in a final draft, should the Office and the Bank resolve the matter consensually. Thank you for your continuing help in this matter.

Should you or the SEC staff have any questions concerning this matter, please contact the undersigned at (202) 874-5210.

Very truly yours,

Ellen Broadman

Ellen Broadman
Director
Securities & Corporate
Practices Division

Attachment

cc: Juan Marcel Marcellino
Assistant Director
Division of Enforcement

Lani Lee
Branch Chief
Division of Enforcement

Attachment to June 17, 1992 Letter
to Mr. Joseph Goldstein
Associate Director, Division of Enforcement

H.R. 5050, 93rd Cong., 1st Sess. (March 1, 1973)

H.R. 5050, 93rd Cong., 1st Sess. (November 19, 1974)

Securities Exchange Act Amendments of 1973: Hearings on H.R. 5050 and H.R. 340 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce, 93rd Cong., 1st Sess., 1780 (1973).

Staff of the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce, 93rd Cong., 2d Sess., (Summary of H.R. 5050) 3 (Comm. Print 1974)

S. 2058, 93rd Cong., 1st Sess. (June 22, 1973)

S. 2058, 93rd Cong., 1st Sess. (July 30, 1973)

S. 2058, 93rd Cong., 1st Sess. (August 3, 1973)

Regulation of Clearing Agencies of Transfer Agents: Hearings on S. 2058 Before the Subcomm. on Securities of Senate Comm. on Banking, Housing and Urban Affairs, 93rd Cong., 1st Sess. 46 (1973)

S. 249, 94th Cong., 1st Sess. (January 17, 1975)

H.R. 4111, 94th Cong., 1st Sess. (March 3, 1975)

H.R. 4111, 94th Cong., 1st Sess. (April 7, 1975)

121 Cong. Rec. S342 (daily ed. January 17, 1975)

121 Cong. Rec. H3230-31 (daily ed. April 24, 1975)

House Comm. on Interstate & Foreign Commerce, Securities Reform Act of 1975, H.R. Rep. No. 94-123, 94th Cong., 1st Sess. 81, 83, 85 (1975).

Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94-75, 94th Cong., 1st Sess. 57-8, 125-8 (1975).

Conference Report, H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 102-3 (1975).

Securities Acts Amendments of 1975: Hearings before Subcomm. on Securities of Senate Comm. on Banking, Housing and Urban Affairs,

94th Cong., 1st Sess. 197 et seq. (1975).

1975 U.S.C.C.A.N. 179 (re: Securities Acts Amendments of 1975) (Legis. History).

P.L. 94-29, 1975 U.S.C.C.A.N. (89 Stat.) 102, 141-46.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF ENFORCEMENT

June 23, 1992

BY FACSIMILE: 874-5279

Ellen Broadman
Director
Securities & Corporate Practices Division
Office of the Comptroller of the Currency
Washington, D.C. 20219

Re: In the Matter of Certain Securities Certificates, File No. HO-2570

Dear Ms. Broadman:

This is in reference to our recent conversation regarding the above-captioned matter and in follow-up to your correspondence to Joseph Goldstein dated June 17, 1992. As we have informed you, the staff's determination at this time is to recommend to the Commission that it institute an enforcement action against Citibank, N.A. ("Citibank") pursuant to the above-referenced formal investigation. In your June 17, 1992 letter, you encouraged the staff to exercise its discretion in favor of not recommending any action against Citibank to the Commission, because the OCC also intends to bring a proceeding against Citibank.

We have carefully considered your request that the Commission not exercise its jurisdiction over this matter and have reviewed the legislative history citations referenced in your June 17 letter. Nonetheless, as we have previously informed you, the staff believes that it is appropriate and necessary for the Commission to institute an enforcement action against Citibank in light of the following circumstances.

First, we believe that the issue of Citibank's conduct which may have resulted in an indeterminate amount of cancelled securities certificates circulating throughout the financial markets raises serious issues about a transfer agent's responsibility to reasonably safeguard securities. Second, we understand from your staff that OCC administrative orders are typically not permanent and that the OCC often vacates its orders after a period of compliance by a respondent. In contrast, Commission orders, including the type we would seek here, are not time limited and are rarely, if ever, vacated as a matter of course.

Ellen Broadman
June 23, 1992
Page 2

Accordingly, we believe it is prudent to recommend that the Commission seek an order which it may enforce should the need arise in the future. Indeed, the legislative history to which you refer emphasizes the fact that the role of the bank regulatory agencies is in no way intended to dilute the Commission's overall responsibility with respect to the transfer agent industry.

Once again, we urge the OCC to consider a joint administrative effort in this matter. We hope that we may continue to build upon the recent and important cooperative relationship reached by our respective agencies in issuing the joint administrative orders in connection with distributions by government sponsored enterprises. Nonetheless, should the OCC decide to proceed with its own order, it does remain our intention to recommend to the Commission that it institute a separate proceeding against Citibank. Should the agencies proceed separately, we remain willing, as we informed counsel for Citibank, to coordinate the actions.

If you have any questions concerning this matter, please call me at (202) 272-2900.

Sincerely,

William R. McLucas
Director

Division of Enforcemen

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

June 24, 1992 BY TELEFAX

William R. McLucas
Director
Division of Enforcement
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Citibank, N.A. ("Bank")

Dear Mr. McLucas:

This will confirm our conversation of June 23, 1992 with Juan Marcelino, Assistant Director, Division of Enforcement, and receipt of your letter of June 23, 1992 concerning the above-captioned bank. During our conversation we provided notice to the SEC Division of Enforcement that the Office of the Comptroller of the Currency ("OCC") has reached a consensual resolution of a proposed administrative proceeding to be instituted under authority of Section 17A of the Securities Exchange Act of 1934 ("Exchange Act"). In that order, the OCC, as the appropriate regulatory agency, would impose a censure and remedial sanctions after finding that the Bank had engaged in numerous violations of the Exchange Act and Securities and Exchange Commission ("SEC") rules governing transfer agent activities. I have enclosed a copy of the order to be issued and the Bank's proposed offer of settlement in connection with this matter. Prior to commencing this proceeding, the OCC consulted with the SEC as provided in Section 17A(d)(3) of the Exchange Act. The OCC staff thanks the staff of the Division of Enforcement for its cooperation and assistance in this matter.

In your letter, you stated that the staff of the Division of Enforcement believes it is both appropriate and necessary for the SEC also to institute a parallel enforcement action against the Bank for violations of the same SEC transfer agent rules. You stated two bases for this position. First, you stated that the Bank's conduct as transfer agent raised serious issues about a transfer agent's responsibility to reasonably safeguard securities. Second, you contrasted the SEC practice of seldom, if ever, vacating SEC orders with OCC practice in vacating administrative orders after a period of compliance by respondents. You stated

your view that the legislative history of the Exchange Act makes clear that Section 17A, while providing enforcement authority to bank regulatory agencies as the appropriate regulatory agencies for financial institutions, including national banks, does not diminish the Commission's overall responsibility with respect to the transfer agent industry.

The OCC believes that there are more persuasive reasons for the SEC to decide not to bring an action in this matter. First, the OCC agrees that the Bank's actions in this matter are serious. For that reason the OCC has taken strong administrative action to remedy the problem, virtually identical to that contemplated by the SEC staff. I also note that, as part of the consultative process required by the Exchange Act and in order to ensure regulatory consistency, the OCC staff has invited the views of the SEC in fashioning appropriate relief against the Bank.

Second, although the OCC may lift those portions of administrative orders providing for remedial measures, the OCC does not vacate self-executing portions of orders, such as suspensions or censures. The Bank will at no time be able to escape its censure. In the event the remedial portion of the order no longer serves a useful purpose in light of the Bank's demonstrated record of compliance with transfer agent rules, as verified by periodic OCC examinations, the OCC may release the Bank from continuing obligations under the order. However, the OCC will continue to conduct regular examinations of the Bank's transfer agent function and scrutinize its compliance with transfer agent rules. Should OCC examinations reveal that the Bank again has failed to observe transfer agent requirements, the OCC will take appropriate enforcement action and will consider the Bank's history of noncompliance when selecting appropriate sanctions.

Finally, I note that while section 17A contains clear language that it does not purport to limit the jurisdiction of the SEC to act against national bank transfer agents, that section does not provide an affirmative grant of authority to act in cases such as this. For this reason the OCC has urged that it, as the appropriate regulatory agency for national banks registered as transfer agents, rather than the SEC, is the appropriate agency to bring an administrative enforcement against national banks generally, and the Bank in particular, to remedy violations of transfer agent rules. Because the OCC has addressed the Bank's violations of law in a manner that is virtually identical to that contemplated by the SEC staff, we again encourage the SEC not to exercise any residual authority it may have to address this same conduct through duplicative administrative enforcement action.

Should you or the SEC staff have any questions concerning this matter, please contact the undersigned at (202) 874-5210.

Very truly yours,

Ellen Broadman

Ellen Broadman
Director
Securities & Corporate
Practices Division

Attachment

EXHIBIT L

Release Letterhead

For: IMMEDIATE RELEASE

Date: [insert date]

The Office of the Comptroller of the Currency (OCC) today announced the settlement of an enforcement action against Citibank, N.A., New York, New York. This action is part of the OCC's continuing investigative and enforcement efforts relating to the securities activities of national banks.

The OCC brought this action against the bank for violations of the Securities Exchange Act of 1934 (Exchange Act) and Securities and Exchange Commission (SEC) transfer agent rules. The OCC censured the bank for its violations and required the bank to institute a number of remedial measures.

The bank consented to the Order and Censure without admitting or denying these charges.

This enforcement action was taken to address violations of the federal securities laws identified during the OCC's ongoing supervision of the bank. The OCC, as the "appropriate regulatory agency" for national bank transfer agents under the Exchange Act, has primary authority to examine national bank transfer agents for compliance with law and, where necessary, to enforce compliance.

As part of its duties as a transfer agent for securities issuers, the bank maintains canceled securities certificates and destroys such certificates when no longer needed. The bank accumulated a significant amount of canceled certificates beginning in 1974, approximately 3500 boxes, with a face value of approximately $111 billion and, in a period of September 1985 to December 1986, it transmitted the canceled certificates to an independent corporation for destruction off the bank's premises. An undetermined, yet significant, number of these certificates survived the cancellation process, some without being perforated. Some of the canceled securities certificates that were to have been destroyed have reappeared since and potentially can be used fraudulently as loan collateral or presented for payment or transfer. The OCC examination revealed a pattern of neglect of the bank's obligations to reasonably safeguard its securities certificates and to make appropriate and timely notifications to federal regulators of the loss or potential theft of these certificates.

In the Order (attached), the OCC found that the bank willfully violated the Exchange Act in failing to assure the safeguarding of these canceled securities certificates in a reasonable manner. The OCC also found that the bank willfully violated the Exchange Act by failing to make required reports of potential thefts or losses of securities to authorities, in violation of SEC rules.

Jimmy F. Barton, Deputy Comptroller for Multinational Banking, said "the action taken today should insure that these problems do not recur at Citibank. This action also should remind other banks of the importance of proper securities cancellation and safeguarding practices."

The SEC and the OCC have been consulting closely on this matter since November 1991. The OCC appreciates the outstanding cooperation and assistance the SEC and its staff have provided in this matter.

UNITED STATES OF AMERICA
BEFORE THE
COMPTROLLER OF THE CURRENCY

IN THE MATTER OF CITIBANK, N.A., NEW YORK, NEW YORK	)	ORDER INSTITUTING PUBLIC PROCEEDINGS, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS

I

The Comptroller of the Currency (hereinafter "COMPTROLLER") deems it appropriate that public proceedings be instituted pursuant to Section 17A(c)(3)(A) of the Securities Exchange Act of 1934, 15 U.S.C § 78q-1(c)(3)(A) ("Exchange Act"), for the purpose of determining whether disciplinary or other remedial action against Citibank, N.A., New York, New York ("BANK") is in the public interest and whether the BANK has committed or omitted any action or omission enumerated in subparagraph (A), (D) or (E) of Paragraph (4) of Section 15(b) of the Exchange Act, 15 U.S.C. §§ 78o(b)(4)(A), (D), or (E). In anticipation of the institution of these proceedings, the BANK has submitted an Offer of Settlement and Undertaking, and Consent to the Entry of Remedial Sanctions ("OFFER AND CONSENT") to the COMPTROLLER. Under the terms of the OFFER AND CONSENT, the BANK, without admitting or denying the allegations and findings contained herein, and solely for the purposes of this proceeding, consents to the COMPTROLLER's issuance

of the findings set forth below and remedial sanctions imposed herein.

The COMPTROLLER, based on the recommendation of his staff, has reviewed the OFFER AND CONSENT made by the BANK and has determined that it is appropriate and in the public interest to accept the OFFER AND CONSENT. Accordingly, the COMPTROLLER has determined to issue the following order.

II

Therefore, it hereby is ORDERED that public proceedings pursuant to Section 17A(c)(3)(A) of the Exchange Act, 15 U.S.C. § 78q-1(c)(3)(A), be and hereby are instituted.

III

On the basis of this Order Instituting Public Proceedings, Making Findings and Imposing Remedial Sanctions ("ORDER"), the COMPTROLLER hereby finds as follows:

A. The COMPTROLLER is the "appropriate regulatory agency" within the meaning of Section 17A(c)(3)(A) of the Exchange Act, 15 U.S.C. § 78q-1(c)(3)(A), to impose sanctions for the violations hereinafter described.

B. The BANK is a national banking association chartered and

examined by the COMPTROLLER pursuant to the National Bank Act of 1864, 12 U.S.C. §§ 27 and 481, respectively, with its main office in New York, New York. The BANK is a wholly-owned subsidiary of Citicorp. The BANK has been at all times pertinent hereto and continues to be registered with the COMPTROLLER as a transfer agent pursuant to Section 17A(c)(2) of the Exchange Act, 15 U.S.C. § 78q-1(c)(2), and 12 C.F.R. § 9.20(a).

C. The BANK acts as transfer agent for at least 2500 securities issues. As part of its transfer agent activities, the BANK processes record ownership changes following securities transactions and is responsible for maintaining canceled securities certificates and destroying such certificates when no longer needed.

D. During the period from at least 1974 to December 1991, the BANK denoted the cancellation of securities certificates by perforating the certificates with its own name or initials, rather than the word "canceled." The BANK in some instances failed entirely to perforate the securities certificates. An undetermined, yet significant, number of the securities certificates survived the cancellation process from 1974 to 1986 without being perforated during the cancellation process.

E. Until 1976, the BANK destroyed all canceled securities

certificates on its premises under the supervision of the BANK's employees. In 1976, the BANK suspended its in-house securities certificate destruction program and began to save all securities certificates indefinitely for possible use in an effort to reconcile an out-of-balance position and computer conversion.

F. Beginning in or about January 1979, the BANK used an affiliate, Citicorp Data Distribution, Inc. ("CDDI") to store the canceled securities certificates between 1974 and 1986 ("Canceled Certificates"). Until at least September 1991, CDDI maintained a locked and limited access warehouse, but had no separate secure space dedicated to the storage of canceled securities certificates and no procedures in effect for the storage and destruction of the Canceled Certificates. There were no dual controls, no locks, no sign-in procedures, no television monitors, no seals on boxes containing canceled securities certificates, or other restrictions placed on BANK or CDDI employees for access to the Canceled Certificates. The Canceled Certificates were treated like all other BANK records committed to CDDI for storage and/or destruction. The Canceled Certificates were stored in more than 3400 boxes. In or about June 1982, the BANK determined to destroy these Canceled Certificates in an effort to relieve storage pressures, and began a destruction program on or about July 1985.

G. In or about July 1985, the BANK sent the Canceled Certificates to two unaffiliated vendors ("cataloguing vendors") for cataloguing to determine a true count of the certificates. The cataloguing vendors and their employees at all times during the cataloguing process had the opportunity to remove the Canceled Certificates from boxes because the Canceled Certificates transmitted to the cataloguing vendors were unattended by BANK employees. The BANK had no means to determine upon the return of the Canceled Certificates whether any had been lost or stolen because the BANK did not have an accurate count of the Canceled Certificates entrusted to it.

H. During the period from August 1985 to March 1986, the BANK received the Canceled Certificates from the cataloguing vendors. The BANK made random tests of the accuracy of the cataloguing process. The sampling technique the BANK used, however, was inadequate to test the accuracy of the cataloguing process. Even if the sampling process were adequate, the BANK failed to use the technique correctly. Once a sample revealed defects in the cataloguing process, the BANK took no further action to verify the remaining contents of that box.

I. Beginning in at least September 1985, the BANK transmitted the Canceled Certificates to a New Jersey corporation, MSM, for destruction. MSM continued to perform the BANK's ongoing securities certificate destruction duties until at least

December 1986. In connection with the choice of MSM to perform document destruction services, no BANK officer inspected the site on which the process would be performed, or retained a copy of the contract for the destruction process. The BANK did not implement a procedure for ensuring the safeguarding of the Canceled Certificates pending their destruction. The BANK did not implement controls to ensure that the Canceled Certificates would be destroyed by MSM. No BANK officer accompanied the Canceled Certificates to the MSM destruction site to oversee or witness the destruction. MSM provided the BANK a guarantee of destruction affidavit for each shipment of the Canceled Certificates it received. The guarantee of destruction affidavit was a pre-printed form detailing the destruction process with a blank space on which to list the contents of the shipment. The BANK also produced a certificate of destruction for each shipment of the Canceled Certificates the BANK transmitted to MSM for destruction in order to verify that the shipment was destroyed. The BANK sent thirteen truckloads of the Canceled Certificates for destruction in this manner.

J. In March 1987, canceled Shell Oil Company securities certificates with a face value of $1.5 million, for which the BANK acted as transfer agent, that should have been destroyed, appeared in Europe for sale or for presentation for payment or transfer at the BANK. These securities certificates were traced to the Canceled Certificates shipped to the MSM

destruction facility. The BANK did not notify the Securities Information Center ("SIC"), an organization designated by the SEC to maintain a database of lost stolen, counterfeit and missing certificates of the presentation of the Canceled Certificates.

K. By at least April 1987, the BANK discovered that MSM did not any longer operate a document destruction operation. Instead, in April 1987, MSM's document destruction site consisted of a vacant lot with an empty trailer. At or about that time, the BANK ceased using MSM to destroy canceled securities certificates and, utilizing CDDI, resumed destroying canceled securities certificates. The BANK has calculated that during the period September 1985 to December 1986 it transmitted approximately three million canceled securities certificates of 2212 securities issues, with a face value of at least $111 billion, to MSM for destruction.

L. During the period August 1989 to December 1991, the BANK discovered additional instances in which the Canceled Certificates were presented for payment or transfer at the BANK. Yet, until late in this period, the BANK failed to take adequate, independent action to determine the amount of the Canceled Certificates potentially outstanding or to warn regulators of the potential problem.

i) In August, October and November 1989, canceled Virginia

Railway securities certificates with a face value of $133,000, for which the BANK acted as transfer agent, were presented to the BANK for payment and or transfer. Some of these securities certificates were not perforated. The BANK traced these canceled securities certificates to the Canceled Certificates shipments transmitted to MSM for destruction. The BANK did not notify the SIC of the presentation of these canceled securities certificates.

ii) In August and October 1990, canceled Georgia Pacific Corporation securities certificates with a face value of $23 million were presented to the BANK and other parties for payment or transfer. These securities certificates were not properly perforated or properly canceled. The BANK also traced these canceled securities certificates to the Canceled Certificates shipments the BANK transmitted to MSM for destruction.

iii) The BANK filed a criminal referral with the COMPTROLLER, the Federal Bureau of Investigation, and the U.S. Attorney on October 4, 1990, regarding Georgia Pacific Corporation canceled securities certificates with a face value of $525,000, rather than the entire amount known to be potentially lost or stolen. The BANK notified the SIC to place a stop on the entire securities issue of Georgia Pacific Corporation securities certificates on or about October 18, 1990.

M. During the first half of 1991, at least forty Canceled Certificates were presented for payment or transfer at the BANK. During the second half of 1991, the number of canceled securities certificates presented for payment or transfer at the BANK increased. A large number of these certificates appeared in Europe, where securities houses in error accepted certificates for payment. Due in part to confusion abroad as to standard U.S. securities cancellation practices, financial institutions also mistakenly accepted the Canceled Certificates as security for loans. These securities certificates also can be traced to the Canceled Certificates shipments transmitted to MSM for destruction.

N. By October 1991, European banks presented canceled securities certificates with an estimated face value of $100 million to the BANK for payment or transfer, all of which were traced to the Canceled Certificates shipments transmitted to MSM for destruction. During the period June 1991 to September 1991, two brokerage houses presented or were asked to present to the BANK for payment or transfer canceled securities certificates with a face value of $540 million. These securities certificates also can be traced to the Canceled Certificates shipments transmitted to MSM for destruction.

O. During the period March 1987 to September 1991, the BANK did not report the suspected loss or theft of any Canceled

Certificates to any federal law enforcement or regulatory agency other than filing one criminal referral for the Georgia Pacific canceled securities certificates. Instead, law enforcement agencies, including the COMPTROLLER, the SEC, the Federal Bureau of Investigation ("FBI"), and Interpol, initiated contact with the BANK to determine the extent of the potential loss or theft of the Canceled Certificates for which the BANK acted as transfer agent by at least November 1991. During the period beginning from at least 1990, the BANK worked with the FBI and Interpol on matters relating to the Canceled Certificates.

P. The Depository Trust Company sent notices to its members on November 22, 1991, December 6, 1992, February 3, 1992, and March 3, 1992 regarding the problem of presentations for payment or transfer, the problem of accepting canceled securities certificates. Included in the list of issues contained in the notices, were 2212 securities issues of Canceled Certificates for which the BANK acted as transfer agent.

Q. The BANK has represented that, commencing in September 1991, it has voluntarily instituted new and improved procedures to ensure compliance with Section 17A(d) of the Exchange Act, 15 U.S.C. § 78q-1(d), and Rule 17Ad-12 thereunder: (i) for the secure storing, safeguarding and destroying of canceled

securities certificates, which included storage in a separate secure space with dual controls, locks, sign-in procedures, television monitors, seals on boxes containing securities certificates and other restrictions placed on BANK and CDDI employees for access to canceled securities certificates; (ii) for the marking of canceled securities certificates with the word "canceled"; (iii) for the shredding of canceled certificates before sending the certificates to any service provider for destruction; and (iv) for the maintaining of policies for the propoer evaluation of and contracting with outside vendors.

R. During the period commencing in or about January 1979 and continuing to in or about December 1991, the BANK willfully[1] violated Section 17A(d) of the Exchange Act, 15 U.S.C. § 78q-1(d), and Rule 17Ad-12 thereunder in that the BANK failed to assure that all securities in the BANK's custody or possession were held in safekeeping and were handled, in light of all facts and circumstances, in a manner reasonably free from risk of destruction, theft or other loss through its failure to properly perforate canceled securities, store canceled securities certificates in a secure area, and adequately verify

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[1] Because the BANK intentionally committed the acts which constitute the violation, its conduct was willful for purposes of Sections 17(f) and 17A of the Exchange Act. There is no requirement that the actor also be aware that he is violating the federal securities laws. <u>See</u> <u>Tager v. SEC</u>, 344 F.2d 5 (2d Cir. 1965).

functions performed by outside contractors entrusted, inter alia, with the data capture and destruction of such securities certificates.

S. During the period commencing in or about May 1987 and continuing to in or about October 1991, the BANK willfully violated Sections 17(f)(1) and 17A(d) of the Exchange Act, 15 U.S.C. §§ 78q(f)(1) and 78q-1(d), and Rule 17f-1(c) thereunder in that the BANK failed to report in a timely manner to the Securities and Exchange Commission or its designee, the Securities Information Center, the discovery of the theft or loss of securities certificates previously thought to have been canceled and destroyed when the securities were presented for transfer in the years 1987, 1989, 1990, and 1991.

T. During the period commencing in or about May 1987 and continuing to in or about October 1991, the BANK willfully violated Sections 17(f)(1) and 17A(d) of the Exchange Act, 15 U.S.C. §§ 78q(f)(1) and 78q-1(d), and Rule 17f-1(c) thereunder in that the BANK failed to report in a timely manner to the Federal Bureau of Investigation upon the discovery of the theft or loss of securities certificates previously thought to have been canceled and destroyed when the securities were presented for transfer in the years 1987, 1989, 1990, and 1991 where there was substantial basis for believing that criminal activity was involved.

IV

In view of the foregoing findings, the COMPTROLLER has determined that it is in the public interest to impose remedial sanctions specified in the OFFER AND CONSENT. Accordingly, IT IS HEREBY ORDERED THAT, EFFECTIVE FORTHWITH:

A. Respondent BANK is hereby censured.

B. Respondent BANK is directed to comply with the following remedial measures designed to prevent the recurrence of the acts, practices and courses of conduct described above. The BANK shall implement such remedial measures within sixty (60) days of the date of this ORDER, unless provided specifically herein to the contrary.

1) The BANK shall implement and maintain procedures, policies, and management information systems, adequately designed to ensure compliance with all rules and regulations pertaining to national BANK transfer agents including, but not limited to:

a) timely notification to appropriate entities of required reporting events:

i) reporting missing, counterfeit or stolen securities, including canceled securities certificates (17 C.F.R. § 240.17f-1);

ii) reporting aged record differences and buy-ins (17 C.F.R. § 240.17Ad-11);

iii) making criminal referrals to the appropriate federal regulatory and law enforcement agencies (12 C.F.R. § 21.11); and

iv) notice of corrective action in response to annual audits (17 C.F.R. § 240.17Ad-13);

b) proper safeguarding of securities certificates held in its possession, or the possession of service providers to the BANK, in accordance with Section 17A(d) of the Exchange Act, 15 U.S.C. § 78q-1(d), and Rule 17Ad-12 thereunder:

i) evaluating and documenting all service providers regarding their ability to perform transfer agent activity services for the BANK;

ii) contracting in writing with all service providers;

iii) perforating or otherwise marking canceled securities certificates with the word "canceled" as soon after receipt as practicable;

iv) storing canceled and uncanceled securities certificates in a physically secure area for a period of not less than six years or such other time as may be required by the Exchange Act and the rules and regulations promulgated

thereunder governing transfer agent activities; and

v) shredding or otherwise mutilating canceled certificates before sending the certificates to any service provider for destruction;

c) assurance that all employees of the BANK and its service providers are reasonably supervised with a view toward preventing violations of the Exchange Act and the rules and regulations promulgated thereunder governing the BANK's transfer agent activities;

d) assurance that all BANK or affiliate or subsidiary employees who perform transfer agent activities are reasonably trained through a continuing program with a view toward preventing violations of the Exchange Act and the rules and regulations promulgated thereunder governing the BANK's transfer agent activities; and

e) assurance that management information systems notify the BANK's internal auditors and the BANK's senior management on a timely basis of:

   i) compliance with the Exchange Act and the rules and regulations promulgated thereunder governing transfer agent activities;

   ii) descriptions of any compliance, administration or operation problems and the corrective

measures taken to address such problems;

iii) audit reports and responses to audit reports;

iv) the contents of reports made to the OCC or the SEC regarding transfer agent activities;

v) the contents of reports made to issuers regarding descriptions of any administration or operation problems and the corrective measures taken to address such problems with regard to its transfer agent activities; and

vi) other significant events regarding transfer agent activities performed by the BANK, its affiliates or subsidiaries, or the BANK's service providers which may affect the ability of the BANK to comply with Paragraphs A through D of Section IV of this ORDER or the Exchange Act and the rules and regulations promulgated thereunder governing transfer agent activities.

2) Within thirty (30) days of the date of this order, the BANK shall either appoint a Committee or designate Citicorp's Audit Committee or some existing committee or subcommittee of the BANK's Board of Directors of at least three directors, no more than one of whom may be an officer of the BANK or any of the BANK's affiliates ("COMMITTEE"). The COMMITTEE shall be responsible for monitoring and coordinating the BANK's adherence to the provisions of this

ORDER. The Committee shall complete or have completed a comprehensive written review of the management of the transfer agent activities. The review shall be designed to identify any management or employee deficiencies by evaluating, at a minimum:

a) the quality and depth of current management;

b) the suitability of each member of the current management for his or her currently assigned duties and functions; and

c) whether the current management needs further augmentation.

C. Respondent BANK be and hereby is notified that the exemption available presently at Rule 17Ad-13(d)(3) is hereinafter unavailable as it relates to the remedial measures of Paragraphs B through D of Section IV of this ORDER. Within thirty (30) days of the date of this ORDER, the BANK shall retain an independent, outside accountant to examine the BANK, and its affiliates and subsidiaries providing support services related to the BANK's transfer agent activities and to prepare for the BANK a report as of September 30, 1992, and annually thereafter, which conforms to all requirements of 17 C.F.R. § 240.17Ad-13, for compliance with the remedial measures of Paragraphs B through D of Section IV of this ORDER. The 1992 report shall specify whether the BANK has adopted and implemented appropriate policies and procedures adequately designed to comply with the remedial measures described in

Paragraphs B through D of Section IV of this ORDER and list any failures to adopt and implement such policies and procedures and describe what corrective measures, if any, have been implemented to correct such failures. This report shall be completed as promptly as practicable and submitted to the Deputy Comptroller for Multinational Banking upon completion.

D. Within ninety (90) days of the date of this ORDER, the BANK shall develop, implement, and maintain a compliance and internal audit program (or, at the BANK's option, an external audit program) appropriate to the needs of the BANK's transfer agent activities. The program shall, at a minimum, provide for (1) the appointment and training of an internal (or an external) officer responsible for compliance with the Exchange Act and the rules and regulations promulgated thereunder governing transfer agent activities who shall report directly to the COMMITTEE, (2) the establishment of semi-annual audits of the BANK and its affiliates and subsidiaries providing support services related to the BANK's transfer agent activities and the submission of semiannual reports to the COMMITTEE. The 1992 report to the COMMITTEE and the semi-annual audits shall specify whether the BANK has adopted and implemented appropriate policies and procedures adequately designed to comply with the remedial measures described in Paragraphs B through D of Section IV of this ORDER and list any failures to adopt and implement such policies and procedures

and describe what corrective measures, if any, have been implemented to correct such failures. A copy of the 1992 report and the semiannual audits shall be submitted to the Deputy Comptroller for Multinational Banking upon completion.

This ORDER shall be effective forthwith and shall be served on the Respondent BANK personally or by certified mail.

WITNESS, my hand and official seal of Office of the Comptroller of the Currency, at Washington, D.C., this _____ day of ________________________, 1992.

____
Steven R. Steinbrink
Acting Comptroller of the Currency

EXHIBIT M

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

July 23, 1992

Joseph Goldstein
Associate Director
Division of Enforcement
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Citibank, N.A. ("Bank")

Dear Mr. Goldstein: Joe

Pursuant to your recent telephone conversations with Ellen Broadman of this office, enclosed please find a letter to Chairman Breeden from the Comptroller of the Currency providing views on the Division of Enforcement's recommendation to institute proceedings against the Bank under authority of the Securities Exchange Act of 1934 ("Exchange Act"). The Office of the Comptroller of the Currency, as the appropriate regulatory agency for national banks registered as transfer agents, is making these comments pursuant to section 17A(d)(3) of the Exchange Act, which provides for such consultation.

We understand from your conversations with Ms. Broadman that you will forward this letter to the Securities and Exchange Commission as part of the package containing the recommendation of the Division of Enforcement.

Should you or the SEC staff have any questions concerning this matter, please contact the undersigned or Ms. Broadman at (202) 874-5210.

Very truly yours,

Robert B. Serino
Deputy Chief Counsel

Enclosure

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

July 23, 1992

Honorable Richard Breeden
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: Citibank, N.A. ("Bank")

Dear Mr. Breeden:

I submit this letter to you and the members of the Securities and Exchange Commission ("SEC") as part of the consultation process contemplated by section 17A(d)(3) of the Securities Exchange Act of 1934 ("Exchange Act"). We are writing to provide the Commission with information that may be useful in evaluating whether to bring an enforcement action against the Bank.

As you know, the Exchange Act establishes the respective roles of our agencies in supervising and disciplining registered transfer agents. Section 17A provides that the OCC is the appropriate regulatory agency to examine, supervise, and discipline national bank transfer agents, and also makes clear congressional intent that the OCC and SEC should consult and coordinate before the institution of enforcement actions.

On June 24, 1992, the OCC censured the Bank and imposed a number of remedial measures for violations of Section 17A of the Exchange Act. The action was based on serious deficiencies in Citibank's transfer agent operations for canceling and safeguarding securities certificates and the Bank's failure to make required reports after learning of potential losses or thefts of securities. The action was taken after full consultation with the SEC staff.

Consultation began as early as November 1991 when the SEC's Division of Market Regulation provided the OCC with information on these problems. The OCC staff and, subsequently, the SEC Division of Enforcement, commenced investigations to develop the facts. On May 14, 1992, the OCC staff advised the SEC staff of the decision to recommend to the Comptroller the initiation of an administrative enforcement action. The OCC staff also expressed the view that the OCC, as the appropriate regulatory agency for national bank

transfer agents, rather than the SEC has jurisdiction to bring this action.[1] Moreover, because the OCC was acting to address the Bank's violations of law in a manner virtually identical to that contemplated at the time by the SEC staff, and since the SEC had other avenues available for expressing its views on the problems at Citibank, the OCC questioned whether a duplicative enforcement action was necessary. At this same time, as part of the consultative process required by the Exchange Act and in order to ensure regulatory consistency, the OCC staff invited the views of the SEC in fashioning appropriate relief against the Bank. On two occasions, beginning on June 8, 1992, OCC staff transmitted draft enforcement documents for comment by SEC staff.

At no time during this process did the SEC staff express any disagreement with proposed remedies contemplated by the OCC staff or the contents of proposed enforcement documents. Rather, the staff of the Division of Enforcement communicated that it had no comments concerning the draft order the OCC staff proposed to issue in this matter.[2]

Although the violations of law committed by the Bank were serious, the action taken by the OCC fully addressed those violations and

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[1] The OCC staff also discussed with your staff concerns about the SEC's jurisdiction to bring an action against the Bank as a transfer agent in light of the fact that Section 17A of the Exchange Act expressly grants to the OCC, as the appropriate regulatory agency, the primary responsibility for enforcing compliance by national bank transfer agents. Although this Section states that the above grant of authority to the OCC does not diminish the Commission's authorities over the transfer agent industry, Section 17A provides no affirmative grant of enforcement authority over national banks to the SEC. This statute reflects congressional intent that the OCC, as the primary supervisor for national banks, bring enforcement actions against these entities and that duplicative actions by the SEC be avoided.

[2] In a letter dated two days before OCC took action against the Bank, SEC staff did state that an additional SEC action was warranted because of the serious nature of the violations and because remedial provisions in OCC orders are not perpetual. We note that the OCC does not vacate self-executing portions of orders, such as suspensions or censures. Thus, Citibank will at no time be able to escape its censure. The OCC has released banks from rehabilitative obligations under orders when such obligations no longer serve a useful purpose in light of a bank's demonstrated record of compliance, as verified by periodic OCC examinations. Also, the OCC conducts regular examinations of banks to scrutinize ongoing compliance with applicable laws. If subsequent violations are identified, the OCC will take appropriate enforcement actions and consider the bank's history of noncompliance in selecting sanctions.

required remedial action designed to ensure that these problems do not reoccur. We encourage the SEC to consider whether a sequential enforcement action by the SEC, given that the Bank already is subject to the OCC's order, would provide any additional benefits to the public.

The OCC has supported and will continue to support the efforts of the SEC in carrying out its responsibilities for addressing violations of the federal securities laws and hopes to maintain a high level of cooperation with SEC staff to assist with those efforts. We appreciate the cooperative relationship that has developed between our staffs and that has enhanced both agencies' ability to effectuate the public policies underlying the laws we each enforce.

We appreciate this opportunity to communicate our views and your attention to our concerns.

Very truly yours,

Stephen R. Steinbrink
Acting Comptroller of the Currency

EXHIBIT N

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

Litigation Release No. 13474 / December 17, 1992

SECURITIES AND EXCHANGE COMMISSION v. CITIBANK, N.A., U.S. District Court for the District of Columbia, Civil Action No. 92-2833 (CRR) (U.S.D.C. December 17, 1992).

The Securities and Exchange Commission announced both the filing of a Complaint for a Civil Money Penalty in the U.S. District Court for the District of Columbia against Citibank, N.A. ("Citibank"), as well as the institution of an administrative cease and desist proceeding against Citibank.

The Complaint in the Civil Money Penalty action alleges that Citibank violated Section 17(f) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 17f-1 thereunder as a result of Citibank's failure to file Missing/Lost/Stolen/Counterfeit Securities Reports on Form X-17F-1A ("Securities Reports") with the Commission or its designee on a timely basis. Without admitting or denying the allegations, Citibank consented to the entry of Final Judgment of a Civil Money Penalty in the amount of $750,000.

According to the Complaint, from 1984 to 1987, Citibank, in its function as a transfer agent, hired MSM Corporation ("MSM"), a now-defunct paper recycling firm, to destroy cancelled corporate bond certificates with a total face value exceeding $111 billion. An unknown number of the cancelled certificates, however, were not destroyed. Since 1987, Citibank has received information indicating that cancelled securities with a face value of at least several hundred million dollars have purportedly surfaced in the U.S. and foreign markets. Cancelled certificates have been fraudulently represented as legitimate, negotiable securities and offered and sold, or pledged as collateral for loans. Potential losses to brokerage firms and banks mistakenly honoring the cancelled certificates exceed several million dollars.

A number of the cancelled certificates that have surfaced do not bear any stamp or other physical mark indicating cancellation. The remainder of the cancelled certificates that have surfaced are perforated with the bank's initials and date in the lower corner of the certificate, to signify Citibank's cancellation. In some instances, however, the perforations have not been detected, or in instances where detected, have been misinterpreted as official notarization.

According to the Complaint, cancelled certificates that should have been destroyed by MSM first surfaced in Europe in March, 1987. During 1990 and 1991, the number of presentments and other appearances of certificates that Citibank turned over to MSM

continued to increase. It was not until October 28, 1991, however, that Citibank filed a Securities Report regarding all of the cancelled certificates of which Citibank was then aware it had turned over to MSM.

The Complaint seeks, and Citibank consented to pay, a civil money penalty of $750,000, based on Citibank's failure to file timely Securities Reports for the securities issues from which cancelled certificates appeared from October 15, 1990, the effective date of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 authorizing the Commission to seek a money penalty in civil actions, to October 28, 1991, when Citibank filed its Securities Report referenced above.

In a collateral proceeding, the Commission instituted a public administrative proceeding against Citibank and simultaneously accepted Citibank's Offer of Settlement consenting to the Commission's Order that Citibank permanently cease and desist from committing or causing any violations or future violations of Sections 17(f)(1) and 17A of the Exchange Act and Rules 17f-1 and 17Ad-12 thereunder. See In the Matter of Citibank, N.A., Exchange Act Release No. 31612 (December 17, 1992).

In that proceeding, the Commission found that when Citibank turned the cancelled certificates over to MSM, Citibank's practices, policies and procedures with regard to the cancellation and destruction of certificates were inadequate, in violation of Section 17A of the Exchange Act and Rule 17Ad-12 thereunder. The Commission also found that Citibank violated Section 17(f)(1) of the Exchange Act and Rule 17f-1 thereunder based on Citibank's failure to file the timely Securities Reports referenced above. The Commission ordered that Citibank permanently cease and desist from committing or causing any violations and future violation of such provisions.

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

92 2833

RICHEY, J. CRR

SECURITIES AND EXCHANGE COMMISSION, 450 Fifth Street, N.W. Washington, D.C. 20549 (202) 504-2220, Plaintiff, v. CITIBANK, N.A. Defendant.	CIVIL ACTION NO. ________ DEC 17 1992 COMPLAINT FOR A CIVIL MONEY PENALTY

Plaintiff Securities and Exchange Commission (the "Commission"), for its Complaint For A Civil Money Penalty, alleges, upon information and belief, that:

1. Defendant Citibank, N.A. ("Citibank"), directly or indirectly, has violated Section 17(f)(1) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §78q(f)] and Rule 17f-1 promulgated thereunder [17 C.F.R. §240.17f-1].

2. The Commission, pursuant to authority granted it in Section 17(f) of the Exchange Act [15 U.S.C. §78q(f)], has promulgated the rule set forth in Paragraph 1 above, which was in effect at all times relevant hereto, and is now in effect.

3. The Commission brings this action pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. §78u(d)(3)].

JURISDICTION AND VENUE

4. This Court has jurisdiction of this action under Sections 21(d)(3)(A) and 27 of the Exchange Act [15 U.S.C. §§ 78u(e) and 78aa].

5. Citibank has made use of the means and instrumentalities of interstate commerce and the mails, and means and instruments of transportation and communication in interstate commerce, in connection with the acts, transactions, practices and courses of business alleged herein, certain of which have occurred within the District of Columbia.

DEFENDANT

6. Citibank is a nationally-chartered and federally-insured bank with its principal place of business in New York, New York. Citibank is the largest commercial bank in the U.S., with assets of $163.5 billion as of June 30, 1992. At all times relevant hereto, Citibank was registered with the Office of the Comptroller of the Currency ("OCC") as a transfer agent pursuant to Section 17A(c)(2) of the Exchange Act. On June 25, 1992, the OCC issued an Order Instituting Public Proceedings, Making Findings and Imposing Remedial Sanctions ("Order") In the Matter of Citibank, N.A., to which Citibank consented. In the Order, the OCC issued a censure against Citibank for violations of Sections 17A(d) and 17(f)(1) of the Exchange Act and Rule 17Ad-12 and 17f-1 thereunder and also ordered Citibank to adopt procedures designed to prevent the recurrence of such violations. Citibank, because it is a national bank, is registered as a

transfer agent with the OCC, pursuant to Sections 3(a)(34)(B)(i) and 17A(c)(2) of the Exchange Act [15 U.S.C. §§ 78c(a)(34)(B)(i) and 78qA(c)(2)] . The Commission, however, has jurisdiction to enforce any transfer agent's compliance with the federal securities laws, pursuant to Section 17A(d)(3)(B) of the Exchange Act [15 U.S.C. §78qA(d)(3)(B)]. Citibank's failure to provide timely Missing/Lost/Stolen/Counterfeit Securities Reports on Form X-17F-1A in violation of Section 17(f)(1) of the Exchange Act and Rule 17f-1 thereunder, despite the continuing presentment of purportedly destroyed certificates, warrants a civil money penalty against Citibank.

SUMMARY OF ALLEGATIONS

7. From 1985 to 1987, Citibank, as transfer agent, turned over for destruction, cancelled corporate bond certificates with a total face value exceeding $111 billion, to MSM Corporation ("MSM"), a now defunct paper recycling firm. When Citibank turned the certificates over to MSM, Citibank failed to institute any security precautions or other controls adequate to verify actual destruction. Accordingly, an unknown number of the cancelled certificates were not destroyed. Since 1987, Citibank has received information indicating that cancelled certificates with a face value of at least several hundred million dollars have purportedly surfaced in the U.S. and foreign markets. Cancelled certificates have been fraudulently presented by certain persons as legitimate, negotiable securities and offered and sold, or pledged as collateral for loans. Potential losses

to brokerage firms and banks to date exceed several million dollars.

8. A number of the cancelled certificates which have surfaced do not bear any stamp or other physical mark indicating cancellation. The remainder of the cancelled certificates that have resurfaced are perforated with the bank's initials and date in the lower corner of the certificate, to signify Citibank's cancellation. In some instances, however, the perforations have not been detected, or in some instances where detected, have been mistakenly interpreted for official notarization.

9. When Citibank learned in 1987 that certain of the certificates turned over to MSM for destruction had surfaced, it failed to file with the Commission, or its designee, Missing/Lost Stolen/Counterfeit Securities Reports on Form X-17F-1A ("Securities Reports"). Continuing thereafter and throughout 1990 and 1991, Citibank was aware of presentments and other appearances of cancelled certificates that had been turned over to MSM for destruction. Citibank, however, failed to file Securities Reports with regard to all of the securities turned over to MSM until October 28, 1991.

Citibank's Violations of Section 17(f) of the Exchange Act [15 U.S.C. §78(f)] and Rule 17f-1 [17 C.F.R. §240.17f-1] promulgated thereunder

10. The allegations set forth in Paragraphs 1 through 9 above are realleged and incorporated herein by reference.

11. At various times, beginning in or about March, 1987, and thereafter, Citibank, as a transfer agent, failed to timely report to, among others, the Commission or the Securities Information Center ("SIC"), the Commission's designee for operating the Lost and Stolen Securities Program pursuant to Section 17(f) of the Exchange Act [15 U.S.C. §78q(f)] and Rule 17f-1 [17 C.F.R. §240.17f-1] thereunder, required information about missing, lost, stolen or counterfeit securities certificates on Securities Reports. Registered transfer agents are required to report to the Commission or its designee the discovery of the theft or loss of any securities certificate within one business day of the discovery where there is substantial basis for believing that criminal activity is involved and to report promptly to the FBI, upon discovery of the theft or loss of any securities certificate where there is substantial basis for believing that criminal activity is involved. Registered transfer agents are also required to file Securities Report with the Commission or its designee within one day after the discovery of the theft or loss where criminal action is not suspected when the securities certificate has been missing or lost for a period of two business days.

12. As part of the aforesaid conduct, although Citibank was aware that certificates turned over to MSM for destruction had been surfacing since March, 1987, Citibank failed to file required Securities Reports for all of the certificates and/or securities issues sent to MSM until October 28, 1991, as described more fully in paragraphs 13 to 32 below.

Citibank Cancellation and Perforation of Certificates

13. Citibank's responsibilities as a transfer agent include the cancellation, storage and destruction of securities certificates which have been redeemed, matured, called or otherwise transferred. After Citibank identified in its system that a particular certificate was cancelled, Citibank's procedures required that the certificate be marked as cancelled by perforating the lower edge of the certificate with the date and Citibank's initials.

14. The perforations were made by a Citibank employee manually feeding the certificates into a perforation punching machine. Prior to 1990, Citibank did not have any procedure whereby each certificate was subsequently inspected to verify that each certificate was actually perforated.

15. The perforation process was conducted in a secured area at Citibank's office at 111 Wall Street. Citibank then stored the cancelled certificates pursuant to appropriate retention periods at Citicorp Data Distribution, Inc. ("CDDI"), a subsidiary document archive. Access at CDDI was controlled by and limited to Citibank personnel.

16. Citibank's indentures with issuers typically required that Citibank destroy the certificates after the appropriate storage periods expired. Until 1979, Citibank incinerated the cancelled certificates. Thereafter, Citibank destroyed the cancelled certificates by paper shredder.

17. With either the incineration or shredding destruction method, Citibank's procedures required that a second Citibank employee be present to witness both the transportation of the certificates to the site of the incinerator or paper shredder and the actual destruction of the certificates, referred to as "dual control." Both employees were required to sign certificates of destruction identifying and attesting to the destruction of bond certificates.

Destruction of Certificates Utilizing MSM

18. From 1980 to 1984, while converting its computer system, Citibank imposed a moratorium on the destruction of vital records, including cancelled certificates. Consequently, when the moratorium was lifted in 1984, there was a backlog of over 3,500 boxes of cancelled certificates to be processed for destruction.

19. In order to destroy the backlogged certificates, Citibank decided to retain the services of an outside vendor. Citibank had previously used MSM, a now defunct paper recycling firm, to destroy administrative types of records. In 1985, CDDI began to use MSM to destroy the backlogged cancelled certificates. Citibank engaged the services of MSM without inquiring into MSM's facilities, operations or qualifications. Moreover, Citibank engaged MSM without determining whether MSM was insured or bonded. Citibank did not enter into any written agreement with MSM for its services.

20. Citibank employed several security precautions with regard to destroying the cancelled securities in-house, as set

forth above in paragraphs 15 and 17. With respect to securities turned over to MSM, however, Citibank turned the cancelled certificates over to MSM without requiring any security measures. CDDI employees loaded the cancelled certificates onto a truck hired by MSM. It is not known whether the MSM trucks were sealed or, if sealed, who controlled access to the trucks transporting the cancelled certificates to destruction facilities. Citibank employees did not accompany the MSM trucks or witness the destruction of the certificates.

21. Although Citibank prepared and maintained "certificates of destruction," these forms, which were signed by the truck driver picking up documents from CDDI, merely identified the number of cartons "turned over to MSM for destruction."

22. From October, 1985, to February, 1987, in at least 15 separate shipments, MSM picked up at least 3,000 to 4,000 cartons of cancelled certificates consisting of more than 2,212 securities issues, with a nominal face value exceeding $111 billion. The actual total face amount of the certificates turned over to MSM may have exceeded this amount. In 1987, after MSM had completed picking up the backlogged cancelled certificates, Citibank ceased using MSM.

<u>Appearance of Cancelled Certificates</u>

23. In 1987, after Citibank had completed turning over the certificates to MSM, Citibank learned that certain certificates turned over to MSM had not been destroyed. Specifically, in March 1987, six perforated Shell Oil Company ("Shell") bond certificates

with a total face value of $1.5 million were presented for sale to an office of Shell located in Austria by a person who claimed to have inherited the certificates. Citibank advised Shell that the certificates were not negotiable. In order to remove the certificates from circulation, however, Citibank agreed to pay that person $12,000 in return for the presented certificates plus an additional 150 Shell Certificates. Citibank was also advised of the availability of additional similar certificates.

24. In response, Citibank initiated an investigation in March, 1987. Citibank officials determined that the Shell certificates were included among the certificates turned over to MSM for disposal. Citibank investigators visited MSM to interview company officers and to examine the facility where the certificates had supposedly been destroyed. The investigators were informed by MSM that MSM's disposal plant had been razed in 1985, and that MSM had sent Citibank's documents to other disposal facilities for destruction. Citibank investigators were also informed that MSM truck drivers had merely left Citibank documents at the disposal facilities, without witnessing the destruction. The Citibank investigators believed that the president of MSM lacked credibility and they suspected that MSM had ties to organized crime. Citibank, however, did not take further action or otherwise refer the matter to criminal or regulatory authorities at that time.

25. Citibank learned that additional certificates sent to MSM had not been destroyed when, in August, 1989, an individual presented to Citibank for redemption 133 Virginia Railway bearer

coupon bond certificates with a total face value of $133,000, which he claimed he obtained from an antiques dealer in Europe. The bonds and coupons attached to the bonds were not perforated. Citibank determined that the certificates had been cancelled, refused to make payment and confiscated the certificates. Citibank also determined that the certificates had been turned over to MSM for destruction.

26. Subsequently, in August 1990, two brokerage firms and an individual located in Florida presented for payment a total of 16 Georgia Pacific bond certificates, four of which were not perforated, totalling $525,000. In addition, in October 1990, the U.S. Secret Service confiscated as payment in an undercover drug deal, $8.1 million of various perforated bond issues, including Georgia Pacific bonds. Citibank determined that the certificates were included among those that had been turned over to MSM for destruction.

27. During 1991, the number of presentments and other appearances of cancelled certificates that should have been destroyed by MSM continued to increase. The certificates were, among other things, presented for payment and offered and sold or pledged as collateral for loans from banks and brokers. Citibank has received information indicating that, to date, at least several hundred million dollars face value of cancelled bond certificates which Citibank had turned over to MSM have purportedly surfaced in the U.S. and Europe.

28. Citibank failed to physically mark cancelled certificates with the term "CANCELLED." In some instances, Citibank's perforation marks went unnoticed, were not translated in photocopying or facsimile transmission, or were mistakenly interpreted as official notarization. Moreover, a number of cancelled certificates that have been recovered do not show any perforations or other markings signifying cancellation. Potential losses to date by broker-dealers and banks mistakenly honoring the certificates exceed several million dollars.

Failure to File Timely Securities Reports.

29. On October 18, 1990, Citibank filed a Securities Report for the bonds in the Georgia Pacific issue which, as set forth in paragraph 26 above, it knew had surfaced in August, 1990. Over one year later, on October 28, 1991, Citibank filed a Securities Report for all of the securities issues of which it was then aware had been turned over to MSM. Subsequent thereto, Citibank has filed updates.

30. Citibank was aware as early as in 1987, with the surfacing of the Shell certificates described in paragraph 23 above, that certificates were emanating from the certificates turned over to MSM. Thereafter, and throughout 1990 and 1991, Citibank was aware of the appearances and presentments of such certificates. Citibank failed, however, to file timely Securities Reports.

31. Citibank was aware of a number of cancelled certificates that had appeared or been presented, for which it did not file Securities Reports, from October 15, 1990, the effective date of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, to October 28, 1991, when Citibank filed the Securities Report for all of the securities issues of which it was then aware had been turned over to MSM for destruction.

32. By reason of the foregoing, Citibank violated Section 17(f)(1) of the Exchange Act [15 U.S.C. §78q(f)] and Rule 17f-1 [17 C.F.R. §240.17f-1] promulgated thereunder.

PRAYER FOR RELIEF

I.

Enter an Order pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. §78u(d)(3)] directing Citibank to pay a civil money penalty under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 for violations of Section 17(f) of the Exchange Act [15 U.S.C. §78q(f)] and Rule 17f-1 thereunder [17 C.F.R. §240.17f-1] occurring after October 15, 1990.

II.

And grant such other and further relief as this Court deems just and appropriate.

Respectfully submitted,

Joseph I. Goldstein

Juan Marcel Marcelino

Lani M. Lee
D.C. Bar No. 375776

Duane Desiderio

Attorneys for Plaintiff
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
(202) 504-2220

Dated: , 1992
Washington, D.C.

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

92 2833

SECURITIES AND EXCHANGE COMMISSION, 450 Fifth Street, N.W. Washington, D.C. 20549 (202) 504-2220, Plaintiff, v. CITIBANK, N.A. Defendant.	CIVIL ACTION NO. ________ CONSENT AND UNDERTAKING OF CITIBANK, N.A.

1. Citibank, N.A. ("Citibank"), having acknowledged receipt of the Complaint for A Civil Money Penalty ("Complaint") of the Securities and Exchange Commission ("Commission") in this action, admits the jurisdiction and venue of this Court over it and over the subject matter of this action.

2. Citibank, solely for the purpose of this action or any other action brought by or on behalf of the Commission or to which the Commission is a party, without admitting or denying any of the allegations in the Complaint, except as to jurisdiction and venue to which it admits, and without trial, argument or adjudication of any issue of law or fact, hereby consents to the entry, without further notice, of the Final Judgment of A Civil Money Penalty ("Judgment") annexed hereto and incorporated by reference herein, ordering Citibank to pay a civil money penalty

for violations of Section 17(f)(1) of the Exchange Act [15 U.S.C. §78q(f)] and Rule 17f-1 [17 C.F.R. §240.17f-1] promulgated thereunder.

3. Citibank waives the entry of findings of fact and conclusions of law pursuant to Rule 52 of the Federal Rules of Civil Procedure.

4. Citibank waives any right it may have to appeal from the entry of the annexed Judgment.

5. Citibank recognizes and states that this Consent and Undertaking is entered into voluntarily and that no offer, threat, or promise has been made by the Commission or by any member, officer, agent or representative thereof, to induce it to enter this Consent and Undertakings.

6. Citibank agrees that this Consent and Undertaking shall be incorporated into the Judgment as if fully set forth therein.

7. Citibank agrees that the Judgment may be presented by the Commission to the Court for signature and entry without further notice.

8. Citibank agrees and undertakes to pay a civil money penalty pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. §78u(d)(3)], in the amount of seven hundred fifty thousand dollars ($750,000). Payment shall be made within twp (2) days of the entry of this judgment by U.S. Postal money order, certified check, bank cashier's check, or bank money order, made payable to the U.S. Securities and Exchange Commission, and shall be transmitted by certified mail (return receipt requested) to the

Comptroller
U.S. Securities and Exchange Commission
Mail Stop 2-5
450 Fifth Street, N.W.
Washington, D.C. 20549

under cover of a letter that identifies the defendant, the name and case number of this action, the name of this court and the Commission's case number. A copy of the cover letter shall be transmitted simultaneously to counsel for the Commission.

9. Citibank acknowledges and agrees that this proceeding, the payment of the penalty contemplated as part of the resolution thereof, and its consent to the entry of the Judgment are for the purposes of resolving this civil proceeding only, in conformity with 17 C.F.R. §202.5(f), and do not resolve, affect, or preclude any criminal proceeding which may be brought against it.

10. Citibank agrees that the Court shall retain jurisdiction of this action for the purpose of enforcing the terms and conditions of the Judgment.

Citibank, N.A.

By: David A. Byl
V.P.

Dated: November 20 1992

On this 20 day of November, 1992, David A. Boyle being known to me and who executed the foregoing Consent and Undertaking of Citibank, N.A., personally appeared before me and did duly acknowledge that they executed the same.

Notary Public
My commission expires on July 25, 1994.

APPROVED AS TO FORM:

Brown & Wood by Richard Bradley
Brown & Wood
Attorneys for Defendant
Citibank, N.A.

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

92 2833

SECURITIES AND EXCHANGE COMMISSION, 450 Fifth Street, N.W. Washington, D.C. 20549 (202) 504-2220, Plaintiff, v. CITIBANK, N.A. Defendant.	CIVIL ACTION NO. ________ FINAL JUDGMENT OF A CIVIL MONEY PENALTY

Plaintiff Securities and Exchange Commission (the "Commission") having duly commenced this action by filing its Complaint for A Civil Money Penalty ("Complaint"), and defendant Citibank, N.A. ("Citibank"), in its Consent and Undertaking, having acknowledged service, and having admitted the jurisdiction and venue of this Court over it and over the subject matter of this action; having waived the entry of findings of fact and conclusions of law pursuant to Rule 52 of the Federal Rules of Civil Procedure, and, without admitting or denying any of the allegations made in the Complaint, and without trial, argument or adjudication of any issue of law or fact having consented to the entry without further notice of this Final Judgment of A Civil Money Penalty ("Judgment") ordering Citibank to pay a money penalty for violations of Section 17(f)(1) of the Exchange Act [15 U.S.C. §78q(f)] and Rule 17f-1 [17 C.F.R. §240.17f-1] thereunder, and it further appearing that this Court has

jurisdiction over Citibank and the subject matter hereof, and the Court being fully advised in the premises, and there being no just reason for delay, it is hereby:

I.

ORDERED, ADJUDGED AND DECREED that the annexed Consent and Undertaking of Citibank, N.A. be and the same hereby is incorporated herein with the same force and effect as if fully set forth herein.

II.

FURTHER ORDERED, ADJUDGED AND DECREED that Citibank pay a civil money penalty of seven hundred fifty thousand dollars ($750,000) pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. §78u(d)(3)(B)]. Payment shall be made within two (2) days of the entry of the Final Judgment, by U.S. Postal money order, certified check, bank cashier's check, or bank money order, made payable to the U.S. Securities and Exchange Commission, and shall be transmitted by certified mail (return receipt requested) to:

Comptroller
U.S. Securities and Exchange Commission
Mail Stop 2-5
450 Fifth Street, N.W.
Washington, D.C. 20549

under cover of a letter that identifies the defendant, the name and case number of this action, the name of this court and the Commission's case number. A copy of the cover letter shall be transmitted simultaneously to counsel for the Commission.

III.

FURTHER ORDERED, ADJUDGED AND DECREED that this Court shall retain jurisdiction of this matter for the purpose of enforcing the terms of this Judgment.

The Clerk of the Court hereby is directed to enter this Judgment forthwith.

____

UNITED STATES DISTRICT JUDGE

DATED: ____________________, 1992
Washington, D.C.

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 31612 / December 17, 1992

ADMINISTRATIVE PROCEEDING
File No. 3-7935 / December 17, 1992

In the Matter of CITIBANK, N.A., Respondent.	ORDER INSTITUTING PROCEEDING PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND ORDER OF THE COMMISSION

I.

The Commission deems it appropriate and in the public interest that a public administrative proceeding be, and it hereby is, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether Citibank, N.A. ("Citibank") has committed violations of Sections 17A and 17(f)(1) of the Exchange Act and Rules 17Ad-12 and 17f-1 promulgated thereunder in connection with its transfer agent activities. 1/

II.

In anticipation of the institution of this administrative proceeding, Citibank has submitted an Offer of Settlement which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission or to which the Commission is a party, Citibank consents to the issuance of this Order Instituting

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1/ Also on December 17, 1992, the Commission filed a civil action seeking a civil money penalty against Citibank for violations of Section 17(f)(1) of the Exchange Act and Rule 17f-1 thereunder occurring after October 15, 1990. Simultaneously, Citibank consented to the entry of a judgment ordering Citibank to pay a civil money penalty of $750,000. SEC v. Citibank, N.A., Civil Action No. 92-2833 (CRR) (U.S.D.C. December 17, 1992).

of 1934, Making Findings and Order of the Commission ("Order"), without admitting or denying the matters set forth herein, and to the entry of the findings, and imposition of the order set forth below.

III.

On the basis of this Order and the Respondent's Offer of Settlement, the Commission finds the following:

A. FACTS

1. The Respondent

Citibank is a nationally-chartered, federally-insured bank with its headquarters in New York City. Citibank is the largest commercial bank in the U.S., with assets of approximately $163.5 billion as of June 30, 1992. Citibank is registered with the Office of the Comptroller of the Currency ("OCC") as a transfer agent pursuant to Section 17A(c)(2) of the Exchange Act. 2/

2. Summary

From 1985 to 1987, Citibank, as transfer agent, delivered for destruction, cancelled corporate bond certificates, with a total face value exceeding $111 billion, to MSM Corporation ("MSM"), a now defunct paper recycling firm. An unknown number of the cancelled certificates, however, were not destroyed. Since 1987, Citibank has received information indicating that cancelled certificates with a face value of at least several

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2/ On June 25, 1992, the OCC issued an Order Instituting Proceedings, Making Findings and Imposing Remedial Sanctions ("Order") In the Matter of Citibank, N.A., to which Citibank consented. In the Order, the OCC issued a censure against Citibank for violations of Section 17A(d) and 17(f)(1) of the Exchange Act and Rules 17Ad-12 and 17f-1 thereunder and also ordered Citibank to adopt procedures designed to prevent the recurrence of such violations. Citibank, because it is a national bank, is registered as a transfer agent with the OCC. See Sections 3(a)(34)(B)(i) and 17A(c)(2) of the Exchange Act. The Commission, however, has jurisdiction to enforce any transfer agent's compliance with the federal securities laws. See Section 17A(d)(3)(B). Citibank's failure to provide timely Missing/Lost/Stolen/Counterfeit Securities Reports on Form X-17F-1A despite the continued surfacing of purportedly previously destroyed certificates, warrants the Commission's: (a) issuance of this Order requiring that Citibank permanently cease and desist from committing or causing any violation or future violation of the provisions cited herein; and (b) seeking a civil money penalty as referenced supra footnote 1.

hundred million dollars have purportedly surfaced in the U.S. and foreign markets. Cancelled certificates have been fraudulently represented as legitimate, negotiable securities and offered and sold, or pledged as collateral for loans. Potential losses to brokerage firms and banks to date exceed several million dollars.

A number of the cancelled certificates that have surfaced do not bear any stamp or other physical mark indicating cancellation. The remainder of the cancelled certificates that have surfaced are perforated with the bank's initials and date in the lower corner of the certificate, to signify Citibank's cancellation. In some instances, however, the perforations have not been detected, or in some instances where detected, have been mistakenly interpreted for official notarization.

When Citibank turned the certificates over to MSM for destruction, Citibank failed to institute any security precautions or other controls adequate to verify actual destruction. As a result, Citibank failed to safeguard such securities reasonably, in violation of Section 17A of the Exchange Act and Rule 17Ad-12 thereunder, in that Citibank's practices, policies and procedures with regard to the cancellation and destruction of cancelled certificates were inadequate.

In addition, when Citibank learned in 1987 that certain of the certificates turned over to MSM for destruction had surfaced, Citibank failed to file Missing/Lost/Stolen/Counterfeit Securities Reports on Form X-17F-1A ("Securities Reports"). Continuing thereafter, Citibank was aware of additional certificates being presented or otherwise surfacing. Nonetheless, Citibank failed to file a Securities Report with regard to all of the certificates turned over to MSM until October, 1991, in violation of Section 17(f)(1) of the Exchange Act and Rule 17f-1 thereunder.

3. Citibank's Cancellation and Destruction of Securities Certificates

Citibank's responsibilities as a transfer agent include the cancellation, storage and destruction of securities certificates which have been redeemed, matured, called or otherwise transferred. After Citibank identified in its system that a particular certificate was cancelled, Citibank's procedures required that the certificate be marked as cancelled by perforating the lower edge of the certificate with the date and Citibank's initials. The perforations were made by a Citibank employee manually feeding the certificates into a perforation punching machine. Prior to 1990, Citibank did not have any procedure whereby each certificate was subsequently inspected to verify that it was actually perforated.

The perforation process was conducted in a secured area at Citibank's office located at 111 Wall Street. Citibank then stored the cancelled certificates pursuant to appropriate retention periods at Citicorp Data Distribution, Inc. ("CDDI"), a subsidiary document archive. Access to CDDI was controlled by and limited to Citibank personnel.

Citibank's indentures with issuers typically required that Citibank destroy the certificates after the appropriate storage periods expired. Until 1979, Citibank incinerated the cancelled certificates. Thereafter, Citibank destroyed the cancelled certificates by paper shredder. With either the incineration or shredding destruction method, Citibank's longstanding procedure required that a second Citibank employee be present to witness both the transportation of the certificates to the site of the incinerator or paper shredder and the actual destruction of the certificates, referred to as "dual control." Both employees were required to sign certificates of destruction identifying and attesting to the destruction of bond certificates.

4. <u>Destruction of Certificates Utilizing MSM</u>

From 1980 to 1984, while converting its computer system, Citibank imposed a moratorium on the destruction of cancelled certificates. Consequently, when the moratorium was lifted in 1984, there was a backlog of over 3,500 boxes of cancelled certificates to be processed for destruction.

In order to destroy the backlogged certificates, Citibank decided to use an outside vendor. Citibank had previously used MSM to destroy other types of administrative records. In 1985, CDDI began to use MSM to destroy the backlogged cancelled certificates. Citibank engaged the services of MSM without inquiring into MSM's facilities, operations or qualifications. Moreover, Citibank engaged MSM without determining whether MSM was insured or bonded. Citibank did not enter into any written agreement with MSM for its services.

Despite the security precautions at CDDI referred to above, Citibank turned the cancelled certificates over to MSM without requiring any security measures. CDDI employees loaded the cancelled certificates onto a truck hired by MSM. It is not known whether the MSM trucks were sealed or, if sealed, who controlled access to the trucks transporting the cancelled certificates to destruction facilities. Citibank employees did not accompany the MSM trucks or witness the destruction of the certificates.

Although Citibank prepared and maintained "certificates of destruction," these forms, which were signed by the truck driver picking up documents from CDDI, merely identified the number of cartons "turned over to MSM for destruction." From October 1985,

to February 1987, in at least 15 separate shipments, MSM picked up at least 3,000 to 4,000 cartons of cancelled certificates consisting of more than 2,212 securities issues, with a nominal face value exceeding $111 billion. The actual total face amount of the certificates turned over to MSM may have exceeded this amount. In 1987, after MSM had completed picking up the backlogged cancelled certificates, Citibank ceased using MSM.

5. Appearance of Cancelled Certificates

In 1987, after Citibank had completed all shipments to MSM, Citibank learned that certain certificates turned over to MSM had not been destroyed. In March, 1987, six perforated Shell Oil Company ("Shell") bond certificates with a total face value of $1.5 million were presented for sale to an office of Shell located in Austria by a person who claimed to have inherited the certificates. Citibank advised Shell that the certificates were not negotiable. In order to remove the certificates from circulation, however, Citibank agreed to pay that person $12,000 in return for the presented certificates plus an additional 150 Shell certificates.

In response, Citibank initiated an investigation in March, 1987. Citibank officials determined that the Shell certificates were included among the certificates turned over to MSM for disposal. Citibank investigators visited MSM to interview company officers and to examine the facility in which the certificates had supposedly been destroyed. The investigators were informed by MSM that MSM's disposal plant had been razed in 1985, and that MSM had sent Citibank's documents to other disposal facilities for destruction. Citibank investigators were also informed that the MSM truck drivers had merely left Citibank documents at the disposal facilities, without witnessing the destruction. The Citibank investigators believed that the president of MSM lacked credibility and they suspected that MSM had ties to organized crime. Citibank, however, did not take further action or otherwise refer the matter to criminal or regulatory authorities at that time.

Citibank learned that additional certificates sent to MSM had not been destroyed when, in August, 1989, an individual presented to Citibank for redemption 133 Virginia Railway bearer coupon bond certificates with a total face value of $133,000, which he claimed he had obtained from an antiques dealer in Europe. The bonds and coupons attached to the bonds were not perforated. Citibank determined that the certificates had been cancelled, refused to make payment, and confiscated the certificates. Citibank also determined that the certificates had been turned over to MSM for destruction.

Subsequently, in August 1990, Citibank received from two brokerage firms and an individual located in Florida,

presentments for payment of a total of 16 Georgia Pacific bond certificates, four of which were not perforated, totalling $525,000. In addition, in October 1990, the U.S. Secret Service confiscated $8.1 million of various perforated bond issues, including Georgia Pacific bonds, as payment in an undercover drug deal. Citibank determined that the certificates were included among those that had been turned over to MSM for destruction.

During 1991, the number of presentments and other appearances of certificates that should have been destroyed by MSM continued to increase. The certificates were, among other things, presented for payment and offered and sold or pledged as collateral for loans from banks and brokers. To date, Citibank has received information indicating that at least several hundred million dollars face value of cancelled bond certificates which Citibank had turned over to MSM have purportedly resurfaced in the U.S. and Europe. Potential losses to date by broker-dealers and banks mistakenly honoring the certificates exceed several million dollars.

6. Lack of Timely Securities Reports

Although Citibank first learned in March, 1987, that certain Shell certificates sent to MSM had not been destroyed, as discussed above, Citibank did not file Securities Reports with the Commission or the Securities Information Center ("SIC"), the Commission's designee for operating the Lost and Stolen Securities Program pursuant to Section 17(f) of the Exchange Act. In 1989, Citibank again learned that certain Virginia Railway certificates had surfaced. Citibank, however, failed to file any Securities Report. On October 18, 1990, Citibank filed a Securities Report for the cancelled Georgia Pacific certificates discussed above which surfaced in August, 1990. Thereafter, and during 1991, Citibank was aware of the presentments and other appearances of cancelled certificates. It was not until October 28, 1991, however, that Citibank filed a Securities Report for all the securities issues from which certificates had been sent to MSM.

B. VIOLATIONS

1. Section 17A and Rule 17Ad-12 Thereunder

Rule 17Ad-12 provides, in relevant part, the following:[7]

> Any registered transfer agent that has custody or possession of any . . . securities related to its transfer agent activities shall assure that: (1) All such securities are held in safekeeping and are handled, in light of all facts and circumstances, in a manner reasonably free from risk of destruction, theft or other loss . . . .

Citibank failed to physically mark cancelled certificates with the term "CANCELLED." In some instances, Citibank's perforation marks went unnoticed, were not copied clearly in photocopying or facsimile transmission, or were even mistakenly interpreted as official notarization.

Moreover, a number of cancelled certificates that have been recovered do not show any perforations or other markings signifying cancellation. Citibank failed to implement any subsequent verification or other procedure to ensure that cancelled certificates were actually perforated to indicate cancellation, resulting in the resurfacing of a significant number of cancelled certificates lacking any indications of cancellation.

Citibank failed to implement any procedures to safeguard the certificates turned over to MSM or to verify any of MSM's functions, including whether the documents were actually destroyed. Moreover, during 1985 to 1987, while MSM was utilized to destroy the backlogged cancelled certificates, Citibank continued to destroy currently cancelled certificates in-house. In accordance with longstanding procedure, Citibank required that the destruction, by paper shredders, be under dual control. No similar precautions were instituted when MSM was retained to destroy the certificates.

2. Section 17(f)(1) of the Exchange Act and Rule 17f-1 thereunder

Section 17(f)(1) and Rule 17f-1 require, in pertinent part, that every registered transfer agent report to the Commission or its designee, the SIC, among others, certain information about missing, lost, counterfeit, or stolen securities certificates on a Securities Report. With regard to stolen securities where there is substantial basis for believing that criminal activity was involved, a Securities Report must be filed within one business day of the discovery of the theft or loss and must promptly be reported to the FBI. With regard to missing or lost securities, a Securities Report must be filed one day after the discovery of the loss of any securities certificate where criminal actions is not suspected when the securities certificate have been missing or lost for a period of two days.

Citibank failed to file timely Securities Reports in 1987, 1989 and 1990 with regard to the resurfaced Shell, Virginia Railway and Georgia Pacific certificates, respectively. Thereafter, prior to the October 28, 1991 filing for all the securities issues sent to MSM, Citibank failed to file timely Securities Reports upon learning of the presentment or appearance of a particular cancelled certificate.

IV.

FINDINGS

Based on the above, the Commission finds that Citibank violated Sections 17A and 17(f)(1) of the Exchange Act and Rules 17Ad-12 and 17f-1 promulgated thereunder.

V.

ORDER

Accordingly, IT IS HEREBY ORDERED that Citibank permanently cease and desist from committing or causing any violation, and committing or causing any future violation, of Sections 17A and 17(f)(1) of the Exchange Act and Rules 17Ad-12 and 17f-1 promulgated thereunder.

By the Commission.

Jonathan G. Katz
Secretary

ONE HUNDRED THIRD CONGRESS

JOHN D. DINGELL, MICHIGAN, CHAIRMAN

SHERROD BROWN, OHIO
MARJORIE MARGOLIES-MEZVINSKY, PENNSYLVANIA
HENRY A. WAXMAN, CALIFORNIA
CARDISS COLLINS, ILLINOIS
RON WYDEN, OREGON
JOHN BRYANT, TEXAS
DAN SCHAEFER, COLORADO
CARLOS J. MOORHEAD, CALIFORNIA
JOE BARTON, TEXAS
FRED UPTON, MICHIGAN

REID P.F. STUNTZ, STAFF DIRECTOR/CHIEF COUNSEL

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

April 13, 1994

The Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

This is to acknowledge receipt of your letter of April 4, 1994 and enclosures, with further reference to your testimony before the Subcommittee on March 2, 1994 and in specific response to the Subcommittee's letter of March 11, 1994.

Your transmittal letter noted that the chronology and supporting documentation included information that was nonpublic and sensitive, and requested confidential treatment thereof. On April 8, 1994, in keeping with Subcommittee practice in such matters, Subcommittee counsels met with your agency's General Counsel, Director of the Division of Enforcement, and other appropriate senior Commission staff to review the documents and the bases for your confidential treatment request.

This is to inform you that, notwithstanding the concerns that you raised, the Subcommittee has determined to include these materials in the public hearing record. You testified about the subject "SEC and OCC enforcement actions against Citibank" on the record under oath in a public hearing before the Subcommittee. The records or information relate to closed enforcement proceedings and would appear for the most part to be obtainable under 5 U.S.C. § 552 (the Freedom of Information Act). Finally, the documents present a clear and concrete case study on the issue of coordination and cooperation by securities and banking regulators with respect to their examination and enforcement programs. Recent and pending actions by the bank regulators highlight the problem of overlapping and potentially inconsistent regulation. The effective and efficient administration and enforcement of the federal securities laws, and continued public confidence in that system of regulation, were key issues in the Subcommittee's hearing and the driving force behind repeated calls for the adoption of functional regulation.

The Honorable Arthur Levitt
Page 2

Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

Congress of the United States
House of Representatives
Washington, DC 20515

December 20, 1993

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S. W.
Washington, D. C. 20219

Dear Comptroller Ludwig:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight, respectively, of banks and banking, including deposit insurance, and of securities and exchanges, we are writing with regard to the proposed acquisition of The Dreyfus Corporation (Dreyfus) by Mellon Bank Corporation (Mellon Corp). This proposed transaction raises numerous policy and legal concerns. We understand that no formal notification of the proposed acquisition has been received by your office, but in light of the parties' publicly stated intentions to so proceed, we ask that you address our concerns, as set forth below, before acting on any notification. We understand that many of the issues raised by the proposed transactions have been separately addressed by the OCC and the Federal Reserve Board in various regulations, orders, letters, and interpretative releases. However, the size and the complexity of the proposed transaction and the extensive marketing and advertising of the Dreyfus funds to the public warrant Congressional scrutiny. Thus, we request that you respond to the concerns raised in this letter.

First, we understand that Mellon Corp. currently intends to operate Dreyfus as a subsidiary of its lead bank, Mellon Bank, N.A. (Mellon Bank or Mellon). We are concerned about the implications of this proposed structure for the safety and soundness of Mellon Bank, an FDIC insured institution. We note that in every financial services reform package considered by either the Committee on Banking or the Committee on Energy and Commerce most securities activities, including investment company related activities, were required to be conducted in a separately capitalized subsidiary of the bank holding company, in order to protect the safety and soundness of the bank and the Federal deposit insurance funds and for the protection of investors.

In the case of financial difficulties of Dreyfus or the Dreyfus funds, the bank may seek to provide financial support to the possible detriment of the Federal deposit insurance fund which stands behind its deposits. In the case of financial difficulties of the bank, it may turn to its cash rich subsidiary, Dreyfus, for financial support, to the detriment of the funds managed by the subsidiary. Note that sections 23A and 23B of the Federal Reserve Act restricting transactions with affiliates do not apply to transactions between banks and their operating subsidiaries.

As described in the press, the transaction contemplates that Dreyfus will operate independently of the bank in accordance with the requirements of the Glass-Steagall Act. It is difficult to understand how a wholly owned, or at least 80 percent owned, operating subsidiary can be expected to operate independently of its parent, especially in a context where "synergies" are claimed to exist. Given these concerns, please explain why you believe that the subsidiary's operating structure would not raise safety and soundness concerns and affect the deposit insurance fund.

A second concern with the proposed structure is that there appears to be no statutory basis for the ownership of shares by a bank in an operating subsidiary and, in fact, national banks are prohibited by 12 U.S.C. 24(7) from owning corporate stock. Nonetheless, your office has by regulation (12 C.F.R. 5.34(c)) allowed national banks to engage in activities which are incidental to the business of banking by means of an operating subsidiary corporation. Generally, the OCC has limited the activities of operating subsidiaries to those activities permissible for national banks, arguing that if the bank itself could conduct the activities, there is no legal prohibition to the activities being conducted by a subsidiary. The converse of this argument is that, if the OCC permits the operating subsidiary to engage in a particular activity, the activity could be conducted by the bank itself -- an outcome that has profound safety and soundness implications. Please explain your statutory basis for permitting national bank subsidiaries and how the acquisition of Dreyfus is "incidental to banking."

Thirdly, we believe that a transaction of the magnitude of the one being proposed should be subjected to more stringent scrutiny than would appear to be provided for under OCC rules. The OCC regulations state only that a national bank must notify the OCC by letter detailing the proposed activities of the operating subsidiary. The establishment of the operating subsidiary can take place upon notification by the OCC or within 30 days, unless the 30 days time period is extended. In that case, the establishment may take place only upon written approval by the OCC. This contrasts greatly with the process by which a bank holding company applies to acquire or establish a subsidiary

under section 4(c)(8) of the Bank Holding Company Act, which involves public notice of the application and an opportunity for public comment and review. A transaction of this magnitude calls, at the very least, for such comment and review. Additionally, please explain how you distinguish between "incidental" activities and those "closely related to banking," which are subject to the requirements of the Bank Holding Company Act.

Representatives of Mellon Corp. and of Dreyfus have indicated to us that they intend to undertake a number of safety and soundness and investor protection "commitments" in the notification that they intend to file with the OCC. Please describe these commitments and discuss your views thereon. What is the legal status and enforceability of such voluntary commitments? Recent press reports, e.g., "OCC To Loosen Shackles Of Bank Securities Units," American Banker's Washington Watch, December 6, 1993, indicate that the OCC is drafting new regulations that would free national banks to widen their range of securities activities through the use of operating subsidiaries beyond the level allowed by and without some of the prudential restrictions applied by the Federal Reserve. Please advise us of the content, rationale, and status of any such proposals, as well as their intended impact, if any, on the Mellon-Dreyfus transaction. To what extent would these regulations differ from the voluntary commitments being undertaken by Mellon Corp. and Dreyfus?

We also request your analysis of the application of the Glass-Steagall Act to the proposed transactions and the appropriateness of additional conditions to prevent conflicts of interests. Among other things, under the Glass-Steagall Act, a bank may not be affiliated with any corporation engaged principally in the issue, underwriting, public sale or distribution of securities. 12 U.S.C. 377. Because open-end investment companies engage continuously in issuing and redeeming securities, the Glass-Steagall Act prohibits affiliates of banks from sponsoring, organizing or controlling mutual funds or distributing their shares. Accordingly, we understand that Dreyfus' distribution function will be sold to an independent, third party distributor. How will you ensure that the distributor is truly independent? Please outline the manner in which Dreyfus fund shares will be sold through Mellon such that Mellon will not be considered a distributor of those shares. Who will bear the considerable advertising and marketing expenses involved in the sale of shares of Dreyfus funds? Please explain in detail how Dreyfus' current distribution activities will be handled post-merger.

Further, who will bear the costs associated with complying with the federal securities laws in connection with this transaction? Specifically, please address whether fund shareholders will incur any of the expenses resulting from any proxy solicitation or amendments to the prospectus.

The Glass-Steagall Act has been interpreted to permit banks and bank holding companies to provide certain other services to mutual funds including acting as investment adviser, custodian, administrator, and transfer agent. However, in permitting these services, the Federal Reserve has imposed various restrictions on the relationship between the bank holding company and the mutual funds, including lending, investment, and director, officer, and employee interlock restrictions. See, e.g., Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993). Such restrictions are essential and, in the case where the proposed activities will be conducted by a subsidiary of the bank, additional restrictions and conditions may be warranted. Please explain what conditions, if any, the OCC intends to place on the Mellon-Dreyfus relationship to guard against conflicts of interest.

Howard Stein, Chairman of Dreyfus, has said that the union of Dreyfus and Mellon "will be a new way of serving people on all segments of their financial needs in one place for their entire lives.... You know Toys 'R' Us? This will be Financial Services 'R' Us." See, "New Future For Dreyfus Investors," New York Times, Sunday, December 19, 1993. Although we commend efforts to serve customers better, we are concerned about the adequate protection of fund investors, including Mellon Bank depositors who become shareholders in the Dreyfus funds. The potential for customer and investor confusion is great. The issues of disclosure regarding the uninsured status of such funds, sales practices, sales location, compensation of sales persons, and conversion of trust assets must be addressed when reviewing the proposed transaction. Further, fund investors would lose many of their protections under the federal securities laws if Mellon assumes the role of investment adviser to the Dreyfus funds. As you know, banks that advise mutual funds, unlike nonbank or other mutual fund advisers, are not required to register under the Investment Advisers Act and are not subject to the SEC's regulatory or examination authority. Please provide us with your views of each of these issues as presented in the Mellon-Dreyfus context.

We are also interested in learning more about the background of this proposed transaction. Please inform us of any discussions you or your staff may have had in the past year regarding the proposed transactions, including the parties to the discussions and a detailed description of the substance of the discussions. Were any representations made by you or your staff regarding the likely disposition by the OCC of the proposed transactions and the timing of that disposition.

The Honorable Eugene A. Ludwig
Page 5

Please provide us with the requested responses by the close of business on Friday, January 7, 1994. Thank you for your cooperation and attention to our request.

Sincerely,

HENRY B. GONZALEZ
Chairman, Committee on Banking, Finance and Urban Affairs

JOHN D. DINGELL
Chairman, Committee on Energy and Commerce

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

January 12, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Dingell:

Thank you for the letter dated December 20, 1993, from you and Chairman Gonzalez on Mellon Bank, N.A.'s (Mellon's) proposed acquisition of the Dreyfus Corporation (Dreyfus). Your letter expresses interest in this transaction because of the size of the institutions involved and the significant customer interest in Dreyfus funds and raises the concerns summarized below. We received the operating subsidiary notice for this complex transaction on December 30, 1993, and are currently reviewing the proposal to determine our response. As part of our review, we will carefully consider the legal and policy issues you have raised.

Mellon represents that, should the proposed transaction be permitted, Dreyfus would engage only in mutual fund activities the OCC has previously found to be permissible for national banks and their operating subsidiaries and would discontinue all other mutual fund activities. The OCC will review Mellon's filing to determine if the proposed activities are, in fact, permissible for national banks and their operating subsidiaries. In addition, the OCC will consider the risks and other concerns that may arise because of the magnitude and complexity of the proposed transaction. The OCC would approve the transaction only if all safety and soundness, customer protection, conflict of interest, and related concerns had been fully considered and addressed.

I. The letter asks whether the proposed acquisition of Dreyfus as an operating subsidiary of a national bank raises safety and soundness concerns and affects the deposit insurance fund. Comments are requested on the safety and soundness and investor protection commitments made in the notice and the legal enforceability of these voluntary commitments. The letter also asks whether the OCC will impose additional conditions on the proposed transaction in order to prevent conflicts of interest.

The OCC is carefully evaluating the potential safety and soundness and related deposit insurance issues raised by the proposed acquisition, including the fact that Mellon is

proposing to acquire Dreyfus as an operating subsidiary. The safety and soundness, deposit insurance, and customer protection concerns relating to the mutual fund activities of Dreyfus are similar to those involved in other operating subsidiary proposals involving mutual fund activities that the OCC has approved, but the OCC has never approved an acquisition of this magnitude involving mutual fund activities.[1]

Some of the risks we focus on in reviewing proposed mutual fund activities include operational, regulatory compliance, legal and financial exposure risks.[2] Operational risks may arise from the high volume of mutual fund transactions and the often complicated nature of these transactions. Banks or operating subsidiaries must have adequate technology, personnel, and internal controls to manage this exposure. Regulatory compliance risks also may increase because of the bank's obligation to assure compliance with a number of laws and regulations issued by the OCC, Securities and Exchange Commission (SEC), Internal Revenue Service and National Association of Securities Dealers (NASD). Legal risks may

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[1]National banks have been involved in the management and marketing of mutual funds and pooled accounts for many years. National banks and their subsidiaries may provide investment advice to mutual funds and to customers, may broker mutual funds, may advertise and market their services and may provide a range of administrative services to mutual funds. Administrative services include acting as transfer agent, custodian, and registrar, and providing record-keeping, accounting, and related services. *See, e.g.*, OCC Letter No. 625 (July 1, 1993); OCC Letter No. 622 (April 19, 1993); letter dated January 13, 1993 from Daniel L. Pearson to David E. Johnson; letter dated March 26, 1990 from J. Michael Shepherd to Kenneth L. Bachman, Jr.; letter dated January 14, 1988 from William B. Glidden to Burton L. Raimi, Esq.; OCC Letter No. 403 (December 9, 1987), *reprinted in* Fed. Banking L. Rep. ¶ 85,627 (CCH); OCC Letter No. 386 (June 19, 1987), *reprinted in* Fed. Banking L. Rep. ¶ 85,610 (CCH) ; OCC Letter No. 367 (August 19, 1986), *reprinted in* Fed. Banking L. Rep. ¶ 85, 537; OCC Letter No. 363 (May 23, 1986), *reprinted in* Fed. Banking L. Rep. ¶ 85,533 (CCH); OCC Letter No. 332 (March 8, 1985), *reprinted in* Fed. Banking L. Rep. ¶ 85,502 (CCH); OCC Letter No. 329 (March 4, 1985), *reprinted in* Fed Banking L. Rep. ¶ 85,499 (CCH); letter dated May 9, 1984 from Peter Liebesman to Edward J. McAniff, Esq. Many of these activities have also been approved for bank holding company subsidiaries by the Federal Reserve Board. *See Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993).

[2]Another factor we consider is the capital levels of the bank and the proposed operating subsidiary. Mellon represents that capital considerations support placement of the proposed mutual fund activities within an operating subsidiary of the bank, rather than in an affiliate. Mellon has stated that its desire to place Dreyfus in an operating subsidiary is premised on the significant capital and earnings benefits for Mellon. The OCC will carefully consider the consequences of the structure of the proposed transaction for the capital position of both Mellon and Dreyfus.

arise from potential litigation by customers based on a bank's noncompliance with legal requirements. Finally, when a bank assumes multiple responsibilities relating to mutual funds, financial loss may result if proper controls are not in place. For example, banks that are both investment adviser and sales agent for mutual funds need adequate controls to ensure appropriate ethical, suitability and disclosure standards in selling mutual fund shares to the retail public. It is important to note that the risks that arise from bank involvement in mutual fund activities are not new but already exist in a wide variety of money management and sales activities in which many banks engage. Nonetheless, banks may need enhanced controls and systems to mitigate the increased risk levels resulting from increased involvement in the mutual funds business.

In reviewing the Mellon/Dreyfus proposal, we will evaluate the reasonableness and appropriateness of the proposed risk management controls presented by the management and the board of Mellon and examine controls governing the relationship between Mellon and Dreyfus. For example, we will assess the adequacy and independence of control systems such as management and board oversight, business plans and strategies, written policies and procedures, audit programs and compliance systems. We will not permit the transaction to go forward unless we are satisfied that appropriate controls are in place.

After the OCC concludes its review of the notice, the agency will decide, based on the particular facts, whether to approve the proposal and, if the decision is to approve, what conditions would be appropriate to address any risks and concerns raised by the considerations outlined above. We would not approve this or any other transaction unless we were confident that safety and soundness, customer protection, and conflict of interest concerns had been addressed, either through voluntary commitments on the part of the institutions involved or through formal conditions imposed by the OCC, as appropriate.[3]

In developing appropriate conditions, we will consider the conditions that have been imposed by the Federal Reserve Board, as well as the OCC, on similar transactions in the past. For example, in recent operating subsidiary filings relating to mutual fund activities, the OCC has imposed a range of investor protection conditions (including disclosure and other marketing and sales limitations), capitalization requirements for the subsidiaries, lending limits on bank/subsidiary transactions, operating controls, and a prohibition on engaging in any new activities without notifying the OCC. *See* OCC Letter No. 625; OCC Letter No. 622. The Federal Reserve Board has imposed similar restrictions on its approval of applications by

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[3]A range of statutory and regulatory provisions already govern bank mutual fund activities and address some potential conflicts of interest and safety and soundness concerns. For example, the Investment Company Act provisions apply to mutual funds and their investment advisers, including national banks. Sections 23A and 23B of the Federal Reserve Act apply to transactions between mutual funds and national bank investment advisers to the funds. The Investment Advisers Act applies to a national bank operating subsidiary engaged in providing investment advice.

bank holding companies to engage in activities related to mutual funds. *See, e.g., Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993).

We will also evaluate the adequacy of the voluntary commitments made in the notice. Mellon has committed to adopt a Policy Statement that contains policy guidelines dealing with these issues. The guidelines include various consumer protections, such as disclosure (in the case of sales from bank premises) of the absence of coverage by deposit insurance or guarantee by the bank, interest and principal risks, potential conflicts of interest, and applicable deferred sales charges; restrictions on fund names, sales locations, and compensation practices; procedures for determining suitability of investments; and adequate training of sales personnel. The Policy Statement also includes provisions designed to ensure the independence of the Dreyfus funds and their boards and provides that transactions between the bank and its operating subsidiaries will comply with sections 23A and 23B of the Federal Reserve Act. The Policy Statement also sets out various limitations on credit and securities transactions between the bank holding company and the Dreyfus funds, and provides that Mellon will adopt adequate standards for statutory and regulatory compliance and management control.

If the transaction were to be approved, the OCC would take care to make its examiners fully aware of the voluntary commitments made by Mellon in its notice and direct them to review Mellon's compliance with the Policy Statement Mellon has committed to adopt. If our examiners found any failure to abide by the commitments, the OCC would take appropriate supervisory actions.

OCC conditions could also include compliance with any voluntary commitments made in the notice, if the OCC determined that inclusion was necessary to address concerns raised by the proposed transaction. Should a bank or operating subsidiary fail to comply with any conditions, the OCC could pursue a range of enforcement remedies comparable to those available for violations of law. The OCC could seek cease and desist orders requiring compliance with the conditions and corrective action, civil money penalties and removals from banking in appropriate cases. *See* 12 U.S.C. § 1818(b), (c), (d), (e) and (i)(2).

Due to increasing national bank involvement in mutual fund activities, the OCC is reviewing its examination and supervision procedures to strengthen its oversight and to ensure that these activities are conducted in a safe and sound manner. Because we recognize that bank operating subsidiaries involved in mutual fund activities are also regulated by the SEC, we are working closely with the SEC to coordinate our respective supervisory efforts to enhance their effectiveness.

II. The letter asks us to explain the statutory basis for allowing national bank subsidiaries and to discuss how the acquisition of Dreyfus is "incidental" to banking. The letter also asks us to explain whether the "incidental" to banking standard applicable to operating subsidiaries differs from the "closely related" to banking standard applicable to bank holding company subsidiaries.

National banks have established operating subsidiaries for approximately 28 years under OCC regulations first issued in 1966. Since then, operating subsidiaries have been allowed to engage only in those activities that are part of or incidental to the business of banking. *See* 31 Fed. Reg. 11459 (1966) (codified at 12 C.F.R. § 7.10) (repealed); OCC Interpretive Ruling 7.7376 (repealed); 12 C.F.R. § 5.34.[4]

National banks have authority to establish operating subsidiaries based on the National Bank Act, which allows banks to exercise certain enumerated powers and "all such incidental powers as shall be necessary to carry on the business of banking." *See* 12 U.S.C. § 24(7). Section 24 gives banks broad authority to engage in the business of banking and to exercise powers reasonably necessary to conduct that business. *See* OCC Letter No. 494 (December 20, 1989), reprinted in [1989-1990 Transfer Binder] Fed. Banking L.Rep. (CCH) ¶ 83,083.

The incidental powers of national banks include, at a minimum, all powers that are "convenient and useful" to express powers. *See Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972). Many courts and the OCC believe that incidental powers are broader and include activities similar to traditional banking functions.[5] As the Ninth Circuit has held, the incidental powers standard "must be construed so as to permit new ways of

[4]The OCC will decide the Mellon/Dreyfus proposal under the current regulation. As your letter notes, the OCC is considering revising this regulation as part of its regulatory simplification project. The project involves reviewing all existing OCC regulations to determine whether they are still appropriate and effective. OCC staff are currently reviewing the operating subsidiary regulation, but we have made no final decisions about whether or how to revise it. Any proposed changes would be published for comment and any comments received would be fully considered by the OCC before any final decision is made.

[5]In defining "incidental" powers, the Supreme Court has considered whether the power at issue is a generally adopted method of banks or is similar or related to a common industry practice, whether the power promotes the convenience of the business of banking or is usual and useful given modern competition, and whether the power is generally reasonable and appropriate. *See, e.g., Franklin National Bank v. New York*, 347 U.S. 373, 377 (1954); *Colorado National Bank v. Bedford*, 310 U.S. 120, 140 (1913); *Clement National Bank v. Vermont*, 231 U.S. 120, 140 (1913); *Wyman v. Wallace*, 201 U.S. 230, 243 (1906); *First National Bank v. National Exchange Bank*, 92 U.S. 122, 127 (1876); *Merchants' National Bank v. State Bank*, 77 U.S. 604, 648 (1871).

conducting the very old business of banking." *M & M Leasing Corp v. Seattle First National Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978).

The establishment of operating subsidiaries that carry on the business of banking falls squarely within the incidental powers of banks under both the narrow and broader view. These subsidiaries are a "convenient and useful" means of conducting banking business. *See* 12 C.F.R. § 7.10(c)(2). Because establishment of operating subsidiaries is part of the business of banking, it is not proscribed by 12 U.S.C. § 24(7) provisions on purchasing corporate stock. *See* 12 C.F.R. § 7.10(b). We are reviewing the Mellon/Dreyfus notice to determine whether the activities proposed for the operating subsidiary are part of or incidental to the business of banking.

The "incidental powers" standard for national banks is distinct from the "closely related to banking" test of section 4(c)(8) of the Bank Holding Company Act. The latter test governs the scope of the non-banking activities that may be carried on by subsidiaries of bank holding companies and is subject to interpretation by the Federal Reserve Board. *See* 12 U.S.C. § 1843.

In interpreting the "closely related to banking" test, the Federal Reserve Board has applied standards similar to those that the OCC applies under the "incidental powers" standard. The Board has found an activity "closely related to banking" if banks generally conduct the activity, provide services that are so similar to the activity that they are well equipped to engage in the activity, or provide services so integrally related to the activity as to require provision of the activity. Indeed, the Board has relied on OCC "incidental powers" precedent when making decisions under the "closely related to banking" test. Using the "closely related to banking" test, the Board has permitted bank holding companies to engage in extensive mutual fund activities. *See, e.g., Mellon Bank Corporation*, 79 Fed. Res. Bull. 626 (1993); 12 C.F.R. Part 225.

III. The letter asks if the proposed acquisition should be subjected to more stringent scrutiny than provided for under OCC rules and suggests that the application be published for public comment.

OCC regulations require a national bank to notify the OCC before creating an operating subsidiary. The OCC may extend the 30-day review period when a bank's letter of notification raises issues that require additional information or analysis, and we have done so for the Mellon notice. OCC policy provides for careful scrutiny of novel or significant filings to determine if proposed activities are legally permissible for a national bank and to review proposals for consistency with safe and sound banking practices and consumer protections. Before an operating subsidiary may be established, the OCC may require changes in proposed activities, prohibit proposed activities, impose conditions designed to ensure safe and sound operations, or take other actions deemed appropriate. Under OCC policy, novel or significant filings, such as the Mellon proposal, receive a higher level of review within the Office than routine filings.

The OCC publishes receipt of operating subsidiary notifications in the agency's Weekly Bulletin. Operating subsidiary filings are generally not subject to formal public comment and review because national banks can perform the activities of an operating subsidiary within a department of the bank without prior review by the Office and without any public notice.

Since Mellon has made copies of its filing available to Congress, we expect to receive comments from interested Members of Congress and will give any comments careful consideration. In addition, because of the complexity and size of this proposal, the OCC will subject the notice to stringent scrutiny to make certain we identify and fully respond to any legal or policy issues raised by the proposal. Under these circumstances, we do not believe that there is a need to seek additional public comments.

IV. The letter asks for an analysis of the application of the Glass-Steagall Act to the proposed transaction and how the OCC will ensure the independence of the third party distributor.

As part of our legal review of the notice, we will thoroughly analyze the application of the Glass-Steagall Act and address this issue in our final decision. Pending our complete review and analysis, we are providing you the following summary of the Glass-Steagall analysis provided by Mellon.

Mellon proposes to acquire Dreyfus as an operating subsidiary and limit its mutual fund activities to those permitted for national banks and their operating subsidiaries. We understand that the activities conducted by Dreyfus will include providing brokerage services, investment advice to mutual funds and the public, and providing administrative services to the funds and their shareholders. Mellon has stated that none of the proposed activities will involve underwriting, issue, flotation, public sale or distribution of securities, or other activities precluded by the Glass-Steagall Act.

Mellon has represented that the distribution activities in which Dreyfus currently engages would be sold to an independent distributor selected by the Boards of Directors of the Dreyfus funds, and neither Mellon nor its Dreyfus subsidiary would distribute any funds. Mellon has further represented that the distributor would be independent in terms of both management and control. Neither Mellon nor any subsidiaries of its holding company would own any shares or other securities, or have any interest in the profits of the distributor. The directors, officers and employees of the distributor would not be directors, officers, or employees of Mellon and Dreyfus.

Mellon has represented that the independent distributor would serve as the intermediary between the Dreyfus funds and purchasers of shares in the funds. The distributor would be the "principal underwriter" for purposes of the Investment Company Act of 1940 and would enter into distribution agreements with the Dreyfus funds. The distributor would be identified in the prospectuses for the Dreyfus funds and would send, or arrange for the

sending of, all confirmations to customers. The distributor would receive a fee for its distribution activities as well as for associated regulatory and administrative services that it would provide.

If the OCC were to approve the proposed transaction and Mellon or Dreyfus subsequently violated the legal requirements concerning distributor independence, *see* 12 U.S.C. §§ 78, 377, 378, the OCC would have available its enforcement powers under 12 U.S.C. § 1818 described above. In addition, our examination process would enable us to identify and address problems that might arise with respect to distributor independence.

You have also asked whether the shareholders of the Dreyfus funds would bear certain costs. Costs associated with advertising and marketing the Dreyfus funds and expenses resulting from compliance with federal securities laws, including proxy solicitation or amendments to prospectuses, may be borne by the investment adviser, distributor, or investors in the funds. Rules adopted by the Securities and Exchange Commission under the Investment Company Act permit mutual funds to pass these costs on to their shareholders. *See, e.g.,* Rule 12b-1. If the proposal were to be approved, allocation of these costs in the future would be subject to OCC and SEC oversight.

V. The letter expresses concern about customer confusion and asks for our views on appropriate disclosures and other customer protections that should be applied to Mellon/Dreyfus mutual fund transactions with customers.

We share your concern that bank customers understand the uninsured status of mutual funds and inherent risks of these investments. Last year, the OCC issued Banking Circular 274. The Circular provides that bank customers be given conspicuous disclosures describing the uninsured status of mutual funds and their investment risks, including possible loss of principal. Banks are advised to obtain a signed statement from customers acknowledging receipt of these disclosures to focus consumers' attention on this important information. The Circular also provides guidance on sales location, evaluating the suitability of particular investments for particular customers, compensation of sales personnel, and other sales practices in an effort to avoid customer confusion and afford important customer protections.[6] The OCC is using its examination and supervisory staff to monitor compliance with the guidance in this Circular by all national banks and other entities selling mutual funds from a national bank's premises. As noted in the Circular, the OCC will take appropriate actions to address unsafe and unsound banking practices involving activities described in the Circular and violations of laws arising from mutual fund sales.

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[6]We note that the NASD's Rules of Fair Practice, unlike BC-274, would not subject money market mutual funds, Dreyfus' predominant class of funds, to suitability requirements.

If the OCC were to approve the Mellon/Dreyfus transaction, Dreyfus would continue to be subject to an array of federal securities laws and regulation. As a registered broker/dealer, Dreyfus would be regulated under the Securities Exchange Act of 1934, and the NASD Rules of Fair Practice, and subject to SEC and NASD oversight. As an investment adviser to mutual funds, Dreyfus also would be required to comply with the Investment Company Act and the Investment Advisers Act. Exemptions from the Investment Advisers Act available to national banks do not apply to operating subsidiaries and would not apply to Dreyfus. In addition, the Investment Company Act applies to national banks and operating subsidiaries that offer investment advice to mutual funds. In addition, Dreyfus would be required to comply with all laws applicable to national banks and would be subject to Banking Circular 274.

VI. The letter asks for information on discussions involving the Comptroller and OCC staff in the past year relating to the proposed transaction and any representations made on the likely disposition of the proposed transaction and timing of that disposition.

OCC legal, supervisory and licensing staff have discussed the proposed acquisition with Mellon representatives on several occasions since Mellon advised OCC staff in November of 1993 of its possible acquisition of Dreyfus. OCC participants included the Chief Counsel, the Deputy Comptroller for Multinational Banking, the Assistant Chief National Bank Examiner for Capital Markets, the Deputy Comptroller for Bank Organization and Structure, the Director for Corporate Activity, the Chief Accountant, the Senior Policy Adviser to the Comptroller and members of their staffs. During these discussions, Mellon representatives provided general information on the proposal. OCC staff asked for information relating to a variety of legal and policy issues, including risk management, supervision, and other controls. OCC staff discussed mutual fund activities that the OCC has approved in the past for operating subsidiaries and national banks (described above). Mellon representatives indicated that, if the acquisition were permitted, Dreyfus would engage only in activities that the OCC had previously found to be permissible for national banks. OCC staff indicated that, based on the information provided by Mellon, the proposed mutual fund activities appeared to fall within existing OCC precedent. However, OCC staff stressed they could provide no assurances on approval or conditions that would be required until the OCC had received and reviewed Mellon's written notice. No specific time frames were provided for an OCC response.

In addition, it should be noted that I briefly stopped by a meeting in progress, to pay a courtesy visit to the senior representatives of Mellon who were present. It is not uncommon for me to do so when a senior bank official is in our office for a meeting with OCC staff.

I hope you find this information useful to your oversight efforts. If you have any further questions, please contact me or David Apgar at (202) 874-4890.

Sincerely,

Eugene A. Ludwig
Comptroller of the Currency

cc: The Honorable Henry B. Gonzalez

Congress of the United States
House of Representatives
Washington, DC 20515

January 26, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S. W.
Washington, D. C 20219

Dear Comptroller Ludwig:

This is with reference to your letter of January 12, 1994 responding to a series of questions that we posed on Mellon Bank, N.A.'s (Mellon's) proposed acquisition of the Dreyfus Corporation (Dreyfus).

We are in the process of reviewing this transaction and the responses to our December 20 letters; accordingly, you should expect to hear further from us as additional questions and concerns arise. In the interim, however, we respectfully request your response to the following:

1. Commitments found in the Policy Statement.

You state that, if the transaction is approved, OCC will make its examiners fully aware of the voluntary commitments made by Mellon in its notice and will direct them to review compliance with those commitments. In the case of failure to abide by the commitments, "[t]he OCC would take appropriate supervisory actions." In addition, you state that you could include compliance with any voluntary commitments as a condition for approval. In the event of the bank's or operating subsidiary's failure to meet those commitments, you state that "the OCC could pursue a range of enforcement remedies <u>comparable to those available for violations of law</u> [emphasis supplied]." For example, you cite 12 U.S.C. section 1818(b) which would authorize you to seek a cease-and-desist order based on

> reasonable cause to believe that the bank or any director, officer, employee, agent, or other person participating in the conduct of the affairs of such bank is about to violate, a law, rule, or regulation, <u>or any condition imposed in writing by the agency in</u>

The Honorable Eugene A. Ludwig
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- connection with the granting of any application or other request by the bank or any written agreement entered into with the agency [emphasis supplied].

Which commitments will be made conditions of approval? What supervisory actions can you take for failure to abide by voluntary commitments that are not conditions for approval? Both the SEC and the securities self-regulatory organizations routinely provide detailed information to the investing public regarding enforcement actions pursuant to the federal securities laws. Will the OCC provide similar detailed information to the public regarding OCC supervisory actions relating to Mellon? Please provide us with a copy of the information the OCC currently publishes with respect to its supervisory actions pursuant to section 1818(b).

2. Concerns with the procedure by which the application is reviewed.

In our letter of December 20, 1993, we raised concerns with the process by which the Mellon/Dreyfus transaction would be reviewed by your office and contrasted that with the process mandated under section 4(c)(8) of the Bank Holding Company Act. We note that the federal securities laws and regulations thereunder, like the Bank Holding Company Act, require notice, opportunity for hearing, and approval by order or regulation (see, e.g., self-regulatory organization rules and rule changes (section 19(b)(1) of the Securities Exchange Act of 1934); and, investment company exemptive applications (section 6(c) of the Investment Company Act of 1940)). These procedures provide interested parties, including members of Congress, notice of the filing of applications, an opportunity for comment, and knowledge of the ultimate disposition of the application. The current OCC process provides none of the above. We ask that, in this particular matter, you publish notice of the Mellon/Dreyfus application and request comments on such application from the public prior to making your decision, and that you promptly adopt regulations that would require you to routinely publish summaries of notifications that raise significant or novel legal or policy issues in the Federal Register, provide for an opportunity for comment, and publish the resulting approval order in accordance with specified time periods.

3. Final action on the application.

Your letter of January 12, 1994 was in many respects nonresponsive and inconclusive, indicating that you would address the issues or answer the questions in your final decision. We understand that this is a complex transaction and that you may not have definitive answers at this time. Nonetheless, and particularly given the import of this transaction and the

The Honorable Eugene A. Ludwig
Page 3

nonpublic nature of your proceedings, we call your attention to Rule X, clause 2(b) of the Rules of the U.S. House of Representatives which charges the standing committees of the House to:

> review and study, on a continuing basis, <u>the application, administration, execution</u>, and effectiveness <u>of those laws or parts of laws, the subject matter of which is within the jurisdiction of that committee and the</u> organization and <u>operation of the Federal agencies</u> and entities <u>having responsibilities in or for the administration and execution thereof</u>, in order to determine whether such laws and the programs thereunder <u>are being implemented and carried out in accordance with the intent of the Congress</u> and whether such programs should be continued, curtailed, or eliminated. In addition, each such committee shall review and study <u>any conditions or circumstances</u> which may indicate the necessity or desirability of enacting new or additional legislation within the jurisdiction of that committee (Emphasis added).

Accordingly, we expect that, before you take final action to approve this transaction, you will provide us with prior notice and a prior briefing by you and/or appropriate OCC staff that specifically addresses the legal, policy and regulatory issues raised by the transaction, and provide us with written answers to the questions posed in our letter.

Thank you for your cooperation and attention to this matter. Your prompt response would be appreciated.

Sincerely,

Henry Gonzalez
HENRY B. GONZALEZ
Chairman, Committee on Banking, Finance and Urban Affairs

John D. Dingell
JOHN D. DINGELL
Chairman, Committee on Energy and Commerce

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 8, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
United States House of Representatives
Washington, DC 20515

Dear Chairman Dingell:

Thank you for your letter dated January 26, 1994 in which you raise additional questions regarding the proposed acquisition by Mellon Bank, N.A. (Mellon) of Dreyfus Corporation (Dreyfus). We are progressing with our review of the notice filed by Mellon to establish a subsidiary and acquire Dreyfus on December 30, 1993 (Notice) and we are happy to respond to the issues you raise.

I. **You have asked the OCC to respond to its previous assertion that if the acquisition is approved, the agency would take appropriate supervisory action to review and enforce Mellon's compliance with voluntary commitments. Specifically, you ask the following questions: Which voluntary commitments would be made conditions of approval? What supervisory actions can the OCC take to enforce voluntary commitments that are not conditions of approval? Will the OCC publicize its enforcement actions relating to Mellon?**

Mellon has represented that it would not object if voluntary commitments made in its Policy Statement were included as written conditions. If the OCC were to approve the Notice, the written conditions the OCC at a minimum would likely impose would cover the voluntary commitments set forth in the Policy Statement. Violations of written conditions of approval of an operating subsidiary may result in formal enforcement actions, including cease and desist orders and civil money penalties.

If a voluntary commitment were not set forth as a condition imposed in writing, failure to comply with this commitment could result in formal enforcement action, such as cease and desist proceedings if the violation of that commitment constituted an unsafe or unsound practice. If necessary, the OCC would initiate enforcement action to require a national bank to comply with the mandates of the Interagency Statement on Retail Sales of Nondeposit Investment Products and other policy guidelines governing mutual fund activities if the

noncompliance constituted an unsafe or unsound banking practice. Noncompliance with the Interagency Statement or voluntary commitments would form the basis for informal action such as notifying bank management of the problem and securing the bank's written commitment to correct the problem.

Finally, a national bank's violation of a voluntary commitment in connection with the approval of an operating subsidiary could violate 12 C.F.R. § 5.34 if the bank engaged in an activity not approved for that operating subsidiary. Failure to comply with voluntary commitments could cause the bank to engage in an activity not approved for its operating subsidiary in violation of section 5.34 even if the OCC had approved that activity for other national banks. In that case, the OCC could initiate action to correct the violation of this regulation, including enforcement action where appropriate. The OCC could also withdraw its approval of an operating subsidiary based on the failure to abide by the commitments upon which we based the approval and initiate an enforcement action based on a violation of 12 C.F.R. § 5.34.

The OCC does not publicize informal enforcement actions taken against national banks. The OCC does publicize, however, all formal enforcement actions in its monthly publication *Interpretations and Actions*. Members of the public seeking additional information on any of the actions listed in that publication are invited to examine the public file on the action at the OCC. The publication of formal enforcement actions is mandated by 12 U.S.C. § 1818(u), which requires the OCC to publish and make available to the public any written agreement or final order issued by the agency in connection with a formal enforcement action, including settlement agreements. The OCC would publish any and all formal enforcement actions taken against Mellon in compliance with this mandate.

II. **You have asked that the OCC publish the notice of Mellon's proposed acquisition of Dreyfus and request public comment on the notice prior to making a decision. You further ask the OCC to adopt a regulation requiring it to routinely publish in the Federal Register and request comment on notifications that raise significant or novel legal or policy issues.**

The OCC agrees that Mellon's proposal to acquire Dreyfus raises novel and complex issues on which the public should have an opportunity to comment. On February 23, 1994, the OCC published in the Federal Register a summary of Mellon's proposed acquisition of Dreyfus, as set forth in the Notice. The OCC also published a summary of a notice filed by First Union National Bank of North Carolina (First Union) of its intent to acquire, through proposed operating subsidiaries, two affiliated investment advisory companies, Lieber & Company and Evergreen Asset Management Corporation. The OCC will be accepting comments on the proposal until March 28, 1994.

While the OCC has not generally provided for formal public notice and comment on operating subsidiary filings, we now believe that public comment may be appropriate in cases where the nature of the activities to be carried out in an operating subsidiary, the size of the

transaction, or other unusual factors raise special legal or policy issues. We are currently reviewing all OCC licensing policies in this area, and we plan to request comment on a proposed rulemaking that would include publication of notice in the Federal Register of operating subsidiary notifications that raise novel questions of law or policy.

III. You express concern that the OCC is unable to provide concrete answers to certain questions while the review of the Notice is ongoing. You ask that the OCC provide you with prior notice of any decision on the Notice, brief you on the legal, policy, and regulatory issues raised by the transaction, and provide you with written answers to the questions posed in your December 20, 1993 letter.

We have attempted to answer Congressional inquiries with concrete answers wherever possible, and as our review of the Notice progresses, we will be able to provide you with more complete answers. We recognize your interest in this transaction and we will provide you with a briefing on the issues and answers to questions we are not yet able to answer prior to deciding the notice. We appreciate your patience on this matter.

Very truly yours,

Eugene A. Ludwig
Comptroller of the Currency

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

January 28, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20919

Dear Comptroller Ludwig:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

As a starting point, we have reviewed the copy of the Notice of the transaction and supporting documentation that was delivered by MBC to the Committee on Energy and Commerce on January 3, 1994, as well as your letter of January 12, 1994 responding to the December 20, 1993 Gonzalez-Dingell letter. We have also reviewed the responses of MBC and Dreyfus and of the Securities and Exchange Commission (SEC) to that letter. In order to assist the Subcommittee in its investigation and in preparation for upcoming hearings, your cooperation is requested in providing the following responses, information, and documents by the close of business on Friday, February 18, 1994.

1. Your letter states (p. 2, fn. 2) that "[t]he OCC will carefully consider the consequences of the structure of the proposed transaction for the capital position of both Mellon and Dreyfus." As you know, MBC has stated that "a principal reason" for structuring the transaction along the lines proposed is so that Mellon Bank can consolidate Dreyfus' capital with its own capital base.

   a. Both the Federal Reserve Board (in its Section 20 orders) and the Federal Deposit Insurance Corporation (FDIC) (in 12 C.F.R. section 337.4(b)(3)) have adopted measures to ensure the adequate capitalization of securities subsidiaries and prevent the double-leveraging of securities subsidiaries' capital. Both provide that the parent entity's investment in a securities subsidiary will not be counted toward

satisfaction of the parent entity's capital requirement. Does the OCC make similar provision for ensuring the separate capitalization of national bank subsidiaries? Specifically, what capital conditions <u>may</u> the OCC require in connection with the proposed transaction? Which <u>will</u> it require?

b. Dreyfus Service Corporation (DSC) is registered with the SEC, the NASD and all fifty states as a broker-dealer, and, as such, is subject to necessary and appropriate financial responsibility standards including the applicable net capital requirements under section 15(c)(3) of the Exchange Act. We are concerned that the capital of the Dreyfus broker-dealer subsidiary will be consolidated with that of Mellon Bank, potentially harming the subsidiary's compliance with its financial responsibility requirements under the federal securities laws. Please advise us whether the OCC generally permits banks to consolidate the capital of their securities subsidiaries, and explain what impact the OCC position in this area has on investor protection. How can DSC's capital be counted towards the bank, and also for the securities firm? Can Mellon Bank withdraw capital from Dreyfus to satisfy its banking needs, leaving DSC without enough regulatory capital? What safeguards will the OCC require Mellon Bank to institute to protect and segregate the capital of DSC?

2. In your letter, you also state (p. 3, runover para.) that: "banks may need enhanced controls and systems to mitigate the increased risk levels resulting from increased involvement in the mutual funds business." To what types of controls and systems were you referring? What has the OCC done to <u>require</u> that banks put into place enhanced controls and systems? Has the OCC imposed any across-the-board requirements for enhanced controls and systems? Please provide copies of any such guidelines or regulations.

3. Your letter states (p. 4, para. 3 and p. 8, para. 1) that the OCC could rely on its cease and desist authority under 12 U.S.C. section 1818(b), (c), (d), (e), and (i)(2) in connection with violations by a bank or operating subsidiary of the voluntary commitments, and of the legal requirements concerning distributor independence. Please explain how the OCC would make the showing required by case law interpreting section 1818 (<u>e.g.</u>, that the violation addressed has a reasonably direct effect on the financial integrity and stability of the bank, <u>Gulf Federal Savings and Loan Ass'n v. FHLBB</u>, 651 F.2d 259 (5th Cir. 1981), <u>cert. denied</u>, 458 U.S. 1121 (1982)). Please support and explain how Dreyfus would be "the bank... agent, or other person participating

in the affairs of such bank" within the scope of section 1818(b).

4. Please support and explain your statement (p. 6) that "[b]ecause establishment of operating subsidiaries is part of the business of banking, it is not proscribed by 12 U.S.C. section 24(7) provisions on purchasing corporate stock." Please state whether the OCC still adheres to the reasoning set forth in former 12 C.F.R. section 7.10, and, if so, why that regulation was repealed. In addition, please discuss whether the establishment of operating subsidiaries generally (and Mellon's acquisition of Dreyfus as an operating subsidiary, specifically) can still be considered "incidental" and "necessary to carry on the business of banking" under the standard set forth in the recent Fifth Circuit VALIC opinion (VALIC v. Clarke, 998 F.2d 1295, 1302 (5th Cir. 1993)).

5. With respect to your discussion of costs (p. 8, para. 2), please explain why in this case, where the need for the proxy solicitation has been caused by actions of the adviser, it would be appropriate for the fund shareholders to bear the costs of those solicitations.

6. Your letter (p. 8, para. 3) discusses OCC Banking Circular No. 274 and states that "OCC is using its examination and supervisory staff to monitor compliance with the guidance in this Circular by all national banks and other entities selling mutual funds from a national bank's premises."

   a. Please provide copies of the examination guides and other preparatory materials used in connection with examinations of bank sales of retail nondeposit investment products pursuant to OCC Banking Circular No. 274. Has the OCC staff begun to examine registered broker-dealers pursuant to Banking Circular No. 274? Please provide detailed information regarding any such examinations and whether the OCC has coordinated any such examinations with the SEC. In addition, please provide us with copies of the examination guides used in connection with examinations for compliance with Sections 23A and 23B of the Federal Reserve Act, and explain how Mellon's voluntary compliance with those sections will be examined for, and enforced.

   b. Do you contemplate that (i) the consumer protection guidelines of Banking Circular No. 274 will establish a basis on which formal disciplinary actions will be taken against bank sales personnel who engage in unethical conduct; and (ii) such actions would be statutory disqualifications as that term is defined in section 3(a)(39) of the Securities Exchange Act of 1934? Under what

circumstances would a breach of the consumer protection guidelines give rise to a private right of action? In addition, please outline and discuss the private rights of action that would be available to customers under the National Bank Act in light of such decisions as In re: Fidelity Bank Trust Fee Litigation, No. 93-0025 (ED Pa., Nov. 22, 1993), and In re: Corestates Trust Fee Litigation, No. 92-5526 (ED Pa., Oct. 22, 1993). Would customers damaged by a breach of the OCC's guidelines be afforded the opportunity to arbitrate their complaints with the bank? If your response is yes, please document your analysis.

7. We are interested in clarifying the points you raise in footnote 6 (page 8) regarding the applicability of suitability requirements to money market mutual fund transactions. Footnote 6 states: "We note that the NASD's Rules of Fair Practice, unlike BC-274, would not subject money market mutual funds, Dreyfus' predominant class of funds, to suitability requirements." This statement is untrue.

   Banking Circular 274 specifically incorporates the suitability requirements of the NASD's Rules of Fair Practice. As a general matter, these suitability requirements, found in Article III, Section 2(a), do apply to transactions in money market mutual funds. Specifically, Section 2(a) requires that broker-dealers have a reasonable basis for believing that their securities recommendations are suitable upon the basis of any disclosed facts concerning the customer's financial situation and investment objectives. We note, however, that paragraph (b) of Section 2, which affirmatively requires broker-dealers to obtain information regarding the customer's financial situation and investment objectives does not apply to money market mutual fund transactions. Accordingly, a broker-dealer must simply have a reasonable basis to believe that a particular money market mutual fund is suitable for its customer, but it is not affirmatively required to obtain information in connection with its suitability determination.[1] Please comment.

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[1]As a general matter, we note that there are several cases finding that the suitability requirements were not fulfilled in transactions involving mutual funds. Russell L. Irish. d/b/a Russell L. Irish Investments, SEC Release No. 34-7687 (1965); affd 367 F.2d 637 (CA-1, 1966); cert denied U.S. Sup. Ct. Feb. 13, 1967. Boren & Co., 40 SEC 217 (1960). Thomas Arthur Stewart, 20 SEC 196 (1945).

8. Your letter states (p. 9, para. 1) that "Dreyfus would be required to comply with all laws applicable to national banks and would be subject to Banking Circular 274." How do you envision that conflicts between requirements of the banking laws and requirements of the securities laws will be resolved? Please indicate what specific progress the OCC and the SEC have made in coordinating their regulatory responsibilities with respect to entities that are subject both to the federal banking laws and the federal securities laws. Do you anticipate engaging in (i) coordinated or (ii) duplicate examinations and/or enforcement actions?

9. Mellon's Legal Memorandum notes at page 36 that "[b]anks have increasingly sought to decrease the roles of third party distributors in the marketing of their proprietary mutual funds and commensurately to increase their own role and that of their broker-dealer affiliates." Concerns have been raised that third party distributors in general are often mere shell companies that do very little and that usually subcontract out all activities, including advertising and marketing, to the bank. The small fees typically paid to such distributors bear out the lack of functions. Please explain why an entity that does not perform the functions of marketing, selling, or advertising a mutual fund, as would seem to be the case in the Mellon/Dreyfus situation, would nonetheless be considered by the OCC to be the "distributor" of such fund for Glass-Steagall purposes. What is your understanding of the role contemplated for Dreyfus Service Corporation or any other affiliate of Mellon in the process of marketing shares of the Dreyfus funds? How does that role satisfy the applicable statutory language and its intent?

10. Please advise the Subcommittee whether there are alternative approaches to structuring the Mellon/Dreyfus transaction that would better address the (1) safety and soundness and (2) investor protection concerns raised by the proposed structure. If so, please describe the additional safeguards such alternative structures would provide.

11. Last month, Heine Securities Corporation (HSC) filed a Schedule 13D with the SEC in connection with the purchase of the common stock, par value $0.10 per share of the Dreyfus Corporation. HSC's response to Item 4 thereof states that: "Based upon HSC's review of the available public information concerning the Issuer, the prospective acquiror, the terms of the proposed merger and the process leading to the proposed merger, HSC is not convinced that the merger consideration fully reflects the underlying value of the Issuer." Please

The Honorable Eugene A. Ludwig
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provide us with copies of any information or analyses in your possession that raise questions about the impact of this transaction on the shareholders of Dreyfus or otherwise indicates that the transaction might not be in their best interests. If such information or analyses are not currently in your possession, please take such steps as may be necessary to obtain any such material from the parties of the Mellon/Dreyfus transaction.

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

February 25, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Dingell:

Thank you for your letter dated January 28, 1994 as well as the letter from you and Chairman Gonzalez dated January 26, 1994 concerning the proposed acquisition by Mellon Bank, N.A. (Mellon) of Dreyfus Corporation (Dreyfus). After reviewing our letter of January 12, 1994, you have asked additional questions concerning the proposed transaction. This letter addresses each of the substantive issues set forth in your request as fully as our progress in analyzing the Mellon Notice permits. The OCC continues to evaluate the proposal submitted by Mellon and Dreyfus on December 30, 1993, and we will update you as we finalize our position on the Notice and the issues you have raised. As the OCC reviews its oversight of national banks' involvement with mutual funds, we will consider any appropriate changes to OCC policies in this area.

I. **You have asked the OCC to elaborate on our previous assertion that we will consider the consequences of the proposed transaction on the capital positions of both Mellon and Dreyfus. Specifically, you ask the following questions:**

(A) **Does the OCC require national bank subsidiaries to be separately capitalized so that a parent's investment in an operating subsidiary would not count toward satisfaction of the parent's capital requirements? What capital requirements may the OCC impose in connection with the proposed transaction? Which requirements will the OCC require?**

The OCC requires that national banks hold capital commensurate with the level and nature of all the risks of their business, including the operation of operating subsidiaries. Consistent with Generally Accepted Accounting Principles (GAAP), the OCC requires national banks to consolidate the assets and liabilities of majority owned subsidiaries for reporting purposes in Reports of Condition and Income. The OCC bases its capital requirements under 12 C.F.R. Part 3 on a bank's consolidated assets. While this capital regulation sets forth certain minimum

capital ratios for national banks, it also provides that the OCC may require higher minimum ratios for a bank in view of its circumstances. Twelve C.F.R. § 3.10(h) specifically provides that the OCC may impose a higher minimum ratio on a bank that may be adversely affected by the activities or condition of its holding company, affiliates, or other institutions with which it has significant business relationships.

Mellon currently holds more than $2 billion of capital, approximately $1 billion of which is needed to satisfy minimum regulatory capital requirements. Dreyfus currently maintains approximately $800 million in capital, less than $1 million of which is required to meet its regulatory capital requirements under the SEC's net capital rule. Under current rules, if the OCC approves the Mellon application to buy Dreyfus, the assets and liabilities of the operating subsidiary will be consolidated with Mellon's for purposes of determining new capital requirements. This consolidation would increase Mellon's leverage capital requirement by almost $36 million, an amount significantly greater than the SEC requirement for Dreyfus.

If the OCC approves the proposed acquisition of Dreyfus, Mellon would be required under Part 3 to hold capital against its consolidated assets (which include the assets of its operating subsidiary). Mellon's net investment in Dreyfus would be included in the calculation of capital used to meet those requirements. The OCC would require Dreyfus to satisfy its own capital requirements, including those imposed by the SEC under the net capital rule. If the OCC approved the acquisition but determined that the consolidated capital levels did not adequately protect Mellon from any risks from the mutual funds business of the Dreyfus operating subsidiary as well as from risks arising from Mellon's current activities, the OCC would use its authority under Part 3 to require the bank to maintain additional capital.

Both the Federal Reserve Board (FRB) and the OCC generally require consolidation of parent and subsidiary assets, liabilities and capital for reporting purposes. Both generally require that risk-based capital and leverage ratios be based on consolidated assets. Both permit a parent's net investment in a subsidiary to be included in the calculation of consolidated capital, just as a subsidiary's assets are included in the calculation of the parent's consolidated capital ratios.

The Federal Reserve Board does not have any additional capital requirements for subsidiaries that engage only in activities permitted for banks and bank operating subsidiaries. It has created, however, an additional capital requirement for holding companies that include Section 20 subsidiaries engaged in securities underwriting activities. In these instances, the parent holding company also must meet the risk-based capital requirements after deducting the subsidiary's assets and capital. However, the FRB does not have separate capital requirements that it applies directly to the Section 20 subsidiaries.

The OCC does not rely solely on capital to protect national banks from the risks associated with the mutual funds business. In the event that we approve the proposal, both the OCC and the SEC would supervise Mellon's mutual funds related activities to ensure that they are conducted in accordance with all applicable laws, rules and regulations and in a safe and sound manner. A key factor to the safe and sound operation of a national bank is the development and

maintenance of policies, procedures, and controls to reduce or eliminate potential risks. The OCC continues to study national banks' participation in the mutual fund business and to develop policies and guidelines that protect national banks from the potential risks of the business. Together with the other bank regulatory agencies, we published an Interagency Statement on Retail Sales of Nondeposit Investment Products on February 17, 1994 (Interagency Statement) (Attachment A). This publication, which replaces Banking Circular No. 274, addresses customer disclosure, suitability, training of employees, and other issues that could potentially expose the bank to risks.

The OCC has not yet determined what specific conditions would be placed on Mellon's acquisition of Dreyfus in the event that we approve the proposal. The OCC has broad authority to impose conditions on such an approval, including conditions addressing the capitalization of Mellon and Dreyfus, and protecting against the misuse of capital. At a minimum, if the OCC approves the Notice, we would require that Dreyfus be adequately capitalized. We would impose other conditions necessary to ensure that Mellon would operate in a safe and sound manner.

(B) Does the OCC generally permit banks to consolidate the capital of their securities subsidiaries? What impact does this position have on investor protection? Would the OCC permit Mellon to withdraw capital from Dreyfus and leave Dreyfus undercapitalized for regulatory purposes? What safeguards will the OCC require Mellon to institute to protect the capital of Dreyfus?

The OCC requires national banks to hold capital based on their consolidated assets, including the assets of their subsidiaries, as noted above. This policy has no adverse impact on investor protection because it does not affect capital requirements applicable to the operating subsidiary. If the proposed acquisition were approved, the OCC would require Dreyfus to maintain capital to meet its obligations under the Securities Exchange Act of 1934. The OCC would also require Mellon to hold sufficient capital to account for any additional risks to which we perceive it would be exposed as a result of operating the Dreyfus subsidiary.

As discussed above, Dreyfus has advised us that the SEC currently requires it to hold less than $1 million in capital under the SEC's net capital rule to support its broker-dealer operations. By contrast, Mellon currently holds approximately $1 billion of capital under the requirements of 12 C.F.R. Part 3. In order to be considered well-capitalized, Mellon must hold $1.5 billion. The enormous disparity in the regulatory capital requirements for Mellon and Dreyfus is an indication, however imperfect, of the relative magnitude of the risks inherent in Mellon's bank-related activities and Dreyfus' mutual fund related activities.

The OCC would not permit Mellon to withdraw capital from Dreyfus so as to leave its subsidiary undercapitalized. The OCC would consider it a violation of law and an unsafe and unsound practice for Mellon or Dreyfus to operate without sufficient capital to meet all regulatory obligations, including those required under SEC regulations. If Mellon's or Dreyfus'

capital fell short of any of the OCC or SEC minimum capital requirements, the OCC could initiate action to require appropriate corrective measures, including an enforcement action if appropriate. Thus, while Mellon would reflect the capital of the Dreyfus operating subsidiary on its call reports and other consolidated financial statements in accordance with GAAP, the OCC would use its broad authority to ensure that the operation was adequately capitalized for both banking and securities purposes.

II. You have asked what types of enhanced systems and controls the OCC has required of banks participating in the mutual fund business. You also ask the OCC to explain its previous statement that "banks may need enhanced controls and systems to mitigate the risk levels from increased involvement in the mutual funds business."

The OCC has required national banks participating in the mutual funds business to develop and maintain systems and controls that adequately protect the bank itself, its depositors, and mutual fund investors from the risks associated with the business. One important risk associated with the sale of mutual funds through national banks is customer confusion. The systems and controls necessary to reduce or eliminate these risks will vary depending on the specific facts and circumstances of the bank's participation in the mutual fund business and the unique risks of each business relationship. The OCC has required national banks participating in the mutual funds business to take certain precautionary measures including, but not limited to, disclosing the risks of mutual funds to potential investors, developing and maintaining policies governing conflict of interest prohibitions and suitability of recommendations, prohibiting teller sales, obtaining customer signatures on disclosure forms, prohibiting compensation systems with inappropriate incentives, such as success-based teller referral fees, maintaining adequate subsidiary capital, and ensuring arm's length transactions with operating subsidiaries. Our letter to NationsBank dated April 9, 1993 (Attachment B) provides examples of the types of conditions required of a national bank participating in the mutual fund business through an operating subsidiary. The OCC incorporated many of these conditions into Banking Circular No. 274 and, more recently, the Interagency Statement.

Our statement that "banks may need enhanced controls and systems to mitigate the increased risk levels resulting from increased involvement in the mutual funds business" restates our intention to tailor the required systems and controls to specific situations. As with any national bank activity, the level of participation in the mutual funds business should be considered in analyzing what systems and controls are necessary for a safe and sound operation. A national bank that assumes multiple responsibilities in the mutual funds business may require enhanced or perhaps different systems and controls compared with one that assumes a more limited role. We will consider the scope and magnitude of the Mellon/Dreyfus proposal in deciding whether to approve it and, if necessary, what systems and controls are appropriate.

III. You have asked how the OCC would rely on its cease and desist authority to enforce any voluntary commitments made by Mellon and Dreyfus as well as the legal requirements concerning distributor independence.

Twelve U.S.C. § 1818(b) authorizes the OCC to initiate cease and desist proceedings against an institution-affiliated party based on any violation of law, rule, or regulation, any unsafe or unsound practice, any condition imposed in writing by the agency in connection with the granting of an application, or any written agreement entered into with the agency.

The OCC may include significant voluntary commitments as written conditions in a letter approving a corporate activity or acquisition. Approval letters may state that the conditions are "conditions imposed in writing by the agency" within the meaning of § 1818(b) in order to make our jurisdiction clear to all parties. If an institution-affiliated party subsequently violated or was about to violate one of those provisions, the OCC could initiate cease and desist proceedings to enforce the provision. In the most egregious cases, where the violation in question posed a significant and imminent threat to the bank, the OCC could pursue a temporary cease and desist order under 12 U.S.C. § 1818(c). Once an order is in place, the OCC may specifically enforce it by going into federal court or pursue civil money penalties for violations of the order.

If a policy guideline is not set forth as a condition imposed in writing, the OCC may nevertheless initiate cease and desist proceedings if the violation of that guideline constitutes an unsafe or unsound practice. While the Gulf Federal court interpreted the term "unsafe or unsound practice" in the narrowest sense, that case is not determinative. Other courts, including those in the same circuit, have taken the broader view that the OCC has the expertise to determine whether an activity is unsafe or unsound and to fashion the appropriate relief to prevent future abuses. See Independent Bankers v. Heimann, 613 F. 2d 1164, 1169 (D.C. Cir. 1979); Groos National Bank v. OCC, 573 F. 2d 889, 897 (5th Cir. 1978). The OCC advocates this broader view of the term "unsafe or unsound practice" and would consider initiating enforcement action to require a national bank to comply with the mandates of the Interagency Statement and other policy guidelines governing mutual fund activities if the noncompliance constituted an unsafe or unsound banking practice.

Finally, a national bank's violation of a voluntary commitment in connection with the approval of an operating subsidiary could violate 12 C.F.R. § 5.34. Failure to comply with voluntary commitments could cause the bank to engage in an activity not approved for its operating subsidiary. This would violate OCC regulations requiring national banks to notify the OCC before engaging in any new activity through an operating subsidiary. In that case, the OCC could initiate action to correct the violation of this regulation, including enforcement action where appropriate.

Mellon has represented that it would not object if its voluntary commitments made in the Policy Statement were included as written conditions. If the OCC were to approve the Notice, the written conditions the OCC at a minimum would likely impose would cover the voluntary commitments set forth in the Policy Statement.

IV. You have asked the OCC to support its previous statement that "[b]ecause establishment of operating subsidiaries is part of the business of banking, it is not proscribed by 12 U.S.C. section 24(7) provisions on purchasing corporate stock."

Specifically you ask whether the OCC still adheres to the reasoning of 12 C.F.R. § 7.10 and whether the establishment of operating subsidiaries can still be considered "incidental" and "necessary to carry on the business of banking" under the standard set forth in the recent Fifth Circuit opinion in VALIC v. Clarke.

While certain concepts contained in the former 12 C.F.R. § 7.10 may be useful in analyzing the law on operating subsidiaries, the OCC does not rely on that section in its review of notices such as the Mellon/Dreyfus proposal. The OCC does maintain, however, that the establishment of certain operating subsidiaries is authorized by 12 U.S.C. § 24(7), which permits national banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking." Twelve C.F.R. § 5.34 provides that a national bank may engage in such activities through an operating subsidiary upon filing proper notice and receiving approval from the OCC. We take exception to the decision in the VALIC case and continue to challenge that decision in the courts. We should also note that federal courts in other circuits interpret section 24(7) more broadly. For these reasons, we believe that the VALIC decision has only limited applicability to the permissible activities of national banks and their operating subsidiaries under 12 U.S.C. § 24(7).

V. You have asked us to explain why it is appropriate for the shareholders of the Dreyfus funds to bear the costs of the proxy solicitations necessary for its acquisition by Mellon.

The OCC has not concluded that it is appropriate for shareholders of the Dreyfus funds to bear the costs of the proxy solicitations necessary for its acquisition by Mellon. The SEC has established rules governing all aspects of proxy solicitations, including allocation of costs. Those rules will govern the proxy solicitation in this case just as they would apply to any publicly traded company. The SEC, therefore, is the appropriate governmental entity to consider whether the allocation of costs complies with its regulatory restrictions.

VI. You have asked the OCC to provide information pertaining to the examination and supervision of national banks participating in the sale of mutual funds. Specifically, you ask the following questions:

(A) You have asked how the OCC conducts examinations of bank sales of retail nondeposit investment products pursuant to OCC Banking Circular 274. Has the OCC begun to examine registered broker-dealers? Does the OCC coordinate with the SEC on these examinations? How will the OCC examine and enforce Mellon's voluntary compliance with Sections 23A and 23B of the Federal Reserve Act?

The OCC has conducted examinations of national banks participating in the mutual funds business. The OCC examines these national banks and their operating subsidiaries, including subsidiaries that are registered broker-dealers. The OCC shares information with the SEC and

is working toward the development of policies to provide for joint examinations and additional coordination in this area.

Following the issuance of Banking Circular No. 274, the OCC developed a set of procedures for examiners to use in testing compliance with the guidelines in the circular. OCC examiners recently have been using these procedures in examinations. Based on the reports from these examinations, the OCC has revised and issued the new examination procedures (Attachment C). These procedures provide guidance to examiners reviewing bank nondeposit investment product retail sales operations, including bank-related marketing and promotional activities. The procedures address disclosure, suitability, employee training and compensation, oversight of third party vendors, and program management. Examiners are advised to review the policies, procedures, systems, and controls and evaluate their effectiveness in terms of the scope of the bank's sales activities.

The OCC has found that most banks are making a good faith effort to comply with Banking Circular No. 274. (We now are asking banks to follow the Interagency Statement.) In most cases, our supervisory efforts have focused on asking banks to enhance their existing policies, systems, and controls. As a result of the examination process, we have directed national banks to enhance their compliance programs by formalizing the suitability review process, ensuring that compensation programs are not structured in a way that results in unsuitable sales, and making required disclosures more conspicuous on pamphlets and brochures.

When examiners find noncompliance with written conditions of approval for an operating subsidiary or voluntary commitments the OCC may require remedial action. If the OCC determined that Mellon had failed to abide by a voluntary commitment to comply with sections 23A and 23B, we would take action to correct the problem. The OCC could initiate such an action under § 1818 if the violation were an unsafe or unsound practice. The OCC could also withdraw its approval of an operating subsidiary based on the failure to abide by the commitments upon which we based the approval and initiate an enforcement action based on a violation of 12 C.F.R. § 5.34.

(B) Does the OCC contemplate that the consumer protection guidelines of Banking Circular No. 274 will establish a basis on which formal disciplinary actions will be taken against bank sales personnel who engage in unethical conduct and that such actions will be statutory disqualifications as that term is defined in section 3(a)(3) of the Securities Exchange Act of 1934?

Failure to comply with the consumer protection guidelines of the Interagency Statement would establish the basis for a formal enforcement action against bank sales personnel only if such action threatened the safety and soundness of the bank or involved a violation of law. If the conduct giving rise to the formal action constituted fraud under the Exchange Act, the action

could be a statutory disqualification under that Act. Noncompliance with the OCC guidelines would form the basis, however, for informal action against either bank sales personnel or the bank itself. Such informal action could include notifying bank management of the problem or securing the bank's written commitment to correct the problem. Management could correct the problem by retraining, transferring, or terminating the employee. If the improper conduct appears to be more widespread, in all likelihood the OCC would ask management to review its training procedures and internal controls and take other appropriate corrective action.

(C) Under what circumstances would a breach of the consumer protection guidelines in Banking Circular No. 274 give rise to a private right of action? Would customers damaged by a breach of the OCC's guidelines be afforded the opportunity to arbitrate their complaints with the bank?

The Interagency Statement does not specifically provide that a violation of its guidelines will give rise to a private right of action. Certain provisions of the circular might give rise to a private right of action under other statutes. Conduct that rises to the level of fraud, including misrepresentation of an investment product or placing a customer in unsuitable investments, could give rise to a private right of action under section 10(b) of the Exchange Act. Customers might also file suit against national banks involved in the sale of mutual funds based on alleged breaches of fiduciary duty, breach of contract, or misleading or deceptive sales practices. The OCC is not aware of any case in which a plaintiff has attempted to establish a private right of action based on Banking Circular No. 274.

Trade associations for the banking industry recently joined together to publish guidelines on retail investment sales by banks. Those guidelines provide that banks may wish to resolve disputes with customers involving securities transactions through arbitration. The publication includes sample arbitration forms to use in such disputes. The OCC supports arbitration as a dispute resolution mechanism.

VII. You have asked the OCC to clarify its statement that the NASD's Rules of Fair Practice would not subject money market mutual funds to suitability requirements.

Both the Interagency Statement and Banking Circular No. 274 provide that bank personnel should recommend the purchase of money market and other mutual funds only after obtaining financial information from the investor and reviewing it to ensure that the investment is suitable. As you have described in your letter, such recommendations by broker-dealers outside of the bank-related sales context are subject to slightly different requirements with respect to money market mutual funds. The OCC has recognized that a bank customer may become confused upon receipt of a recommendation to transfer an insured deposit into a money market mutual fund. The OCC believes that in these circumstances an appropriate suitability requirement affords necessary additional protection for bank customers.

VIII. You have asked how the OCC plans to resolve conflicts between banking and securities laws in the regulation of Mellon after the acquisition of Dreyfus and, more generally, what steps the OCC and the SEC have taken to coordinate their regulatory efforts.

The OCC is working with the SEC to coordinate the administration of banking and securities laws and develop more consistent interagency policies and guidelines in connection with the regulation of banks engaged in mutual funds related activities.

The OCC and SEC share a variety of supervisory and examination information. The OCC has provided the SEC with access to our reports of examination, work papers, and examiners in connection with SEC investigations. We also provide information to the SEC to assist with its review of disclosures relating to bank holding companies with national bank subsidiaries. The OCC refers potential violations of law to the SEC and has brought joint enforcement actions in appropriate cases. Similarly, the SEC has provided the OCC with access to its inspection reports and internal memorandum, and has referred appropriate cases to the OCC.

In connection with our consideration of Mellon's application to acquire Dreyfus, OCC and SEC staffs met to discuss the SEC's procedures for supervising mutual fund companies such as Dreyfus. We inquired about the SEC's experiences with regulating Dreyfus and whether the SEC had any particular concerns we should investigate as we consider the application. We will continue to coordinate with the SEC as we proceed with the review process.

We should also note that senior staffs representing the OCC and SEC have also discussed joint examinations of banks and operating subsidiaries involved in mutual fund activities. OCC and SEC staffs have agreed to develop general guidelines for handling the mechanics of these examinations, including the scope of the examinations, the allocation of work responsibilities, and the preparation of examination reports.

IX. You have asked the OCC to explain why an entity that does not perform the functions of marketing, selling or advertising a mutual fund would be considered a "distributor" of such a fund for Glass-Steagall purposes, i.e. what role will Dreyfus Service Corporation play in the process of marketing shares of the Dreyfus funds and how does that role satisfy the applicable statutory language and its intent?

Mellon has represented that the proposed subsidiaries acquiring Dreyfus would engage only in activities permissible for national banks. National banks generally are not permitted to act as a "distributor" of securities including mutual funds. Thus, Mellon has represented that Dreyfus will resign as distributor of the Dreyfus funds prior to the time the acquisition is consummated. The boards of directors for the individual funds would contract with an independent third party to assume the role of distributor. The distributor would be responsible for sponsoring new funds, selecting wholesale distributors for sales of fund shares, sending or arranging for the sending of confirmations to customers, and for various other regulatory/administrative services

that are typical for a distributor. The distributor would receive a fee for its distribution activities consistent with industry practice.

Although the Glass-Steagall Act does not explicitly define the term "distribution," it has been interpreted by the courts to be limited in scope and generally similar to the traditional "underwriting" of newly issued securities. See Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 207, 217 (1984) (terms "underwriting" and "distribution" traditionally apply to function different from that of securities broker). The Glass-Steagall Act prohibits such activities due to concerns that they are too speculative for national banks and that such activities might subject banks to other subtle hazards. It is true that the third party distributor would not bear the risks traditionally associated with underwriting. It is also true, however, that Mellon would not bear those risks. If the transaction is approved, Mellon and the subsidiaries would not purchase mutual fund shares for their own account and would not put bank assets at risk. Moreover, Mellon and the subsidiaries would not be obligated to sell shares of the Dreyfus funds. Finally, Mellon's ability to lend money to Dreyfus will be restricted. In essence, neither Mellon nor the third party distributor would bear any underwriting risk and Mellon will not be subject to certain subtle hazards related to speculative securities activities.

If the transaction is approved, Mellon would limit its role in marketing to permissible activities such as providing brokerage and investment advisory services to customers and advertising relating to those services. Mellon would also prepare advertisements on specific investment products that conform to market standards. While Mellon would take an active role in marketing, that role would not subject the bank to the type of risks traditionally associated with underwriting.

X. You have asked whether the OCC has identified any alternative approaches to structuring the transaction that would better address the safety and soundness and investor protection concerns raised by the proposed structure.

The OCC is in the process of reviewing the structure proposed by Mellon and Dreyfus to determine whether it is safe and sound for the bank and whether it adequately protects potential investors. The OCC will not approve the proposed transaction unless it meets those high standards. At this point, the OCC has not considered any alternative approaches to the proposed plan. In the event we are unable to approve the plan as submitted, we will review any alternative approaches that the parties choose to submit.

XI. You have asked us to provide you with copies of any information or analyses that raise questions about the impact of the proposed acquisition on the shareholders of Dreyfus or otherwise indicate that the transaction might negatively impact those shareholders.

We have enclosed a copy of the Schedule 13D filed by Heine Securities Corporation. We obtained a copy of this public filing from the SEC in response to your request. The OCC is aware of the commentary in the market about whether Mellon is paying too much or too little to acquire Dreyfus. We believe that shareholders are best positioned to evaluate whether the merger would promote their best interests. Dreyfus will provide its shareholders with the full range of information required under the federal securities laws, including information on the pricing of shares and the impact of the proposed merger on their investments. Shareholders will have the opportunity to review this information before voting on the proposed transaction. Regardless of the OCC's action in this matter, the acquisition will not go forward without the approval of the Dreyfus shareholders.

I hope this information is useful to you. If you have any further questions, please contact me at (202) 874-4900 or David Apgar at (202) 874-4890.

Sincerely,

Eugene A. Ludwig
Comptroller of the Currency

ATTACHMENT "A"

NR 94-21

	Office of the Comptroller of the Currency
Joint Release	**Federal Deposit Insurance Corporation**
	Board of Governors of the Federal Reserve System
	Office of Thrift Supervision

For Immediate Release
February 17, 1994

Regulators Issue Uniform Guidance on Mutual Fund Sales

The federal bank and thrift regulatory agencies today released a joint statement on retail sales of mutual fund and other nondeposit investment products by federally insured financial institutions. The statement supersedes guidance previously issued by each of the four agencies.

Today's action means insured financial institutions will now be operating under the same interagency statement for the provision of mutual fund and other investment services. The statement applies to insured depository institutions offering a mutual fund or other nondeposit investment product sales program at the retail level, either directly or indirectly. It reaffirms the agencies' belief that retail customers must be fully informed about risks associated with mutual fund or other nondeposit investment products. Banks and thrifts recommending or selling such products should ensure that customers are fully informed that the products: (1) are not FDIC insured, (2) are not deposits or other obligations of the institution and are not guaranteed by the institution, and (3) involve investment risks, including possible loss of principal. These disclosures should be conspicuous and presented in a clear and concise manner.

The statement makes clear that tellers should not make specific recommendations about nondeposit investments, qualify customers, or accept orders. It also outlines steps depository institutions should take to minimize the possibility of customer confusion. Among other things, banks and thrifts should:

- advertise and disclose information about mutual fund and other investment products in a manner that clearly differentiates these products from insured deposits;

- obtain a signed statement when a customer opens an investment account acknowledging that the customer has received and understands the disclosures;

- conduct investment sales programs on bank premises in a physical location distinct from the area where retail deposits are taken;

- ensure that investment sales personnel are properly qualified and trained;

- more -

- ensure that sales personnel recommend particular investments that are suitable for the particular customer; and

- ensure that incentive compensation programs are properly structured to protect customers.

Banks and thrifts should adopt written policies and procedures to implement their investment sales programs that are consistent with the joint statement. The agencies will be examining the institutions they supervise for compliance with the joint statement.

The agencies will mail copies of the joint statement to the institutions they regulate.

# # #

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION
OFFICE OF THE COMPTROLLER OF THE CURRENCY
OFFICE OF THRIFT SUPERVISION

INTERAGENCY STATEMENT

ON RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS

February 15, 1994

INTRODUCTION

Recently many insured depository institutions have expanded their activities in recommending or selling to retail customers nondeposit investment products, such as mutual funds and annuities. Many depository institutions are providing these services at the retail level, directly or through various types of arrangements with third parties.

Sales activities for nondeposit investment products should ensure that customers for these products are clearly and fully informed of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to retail customers, depository institutions should ensure that customers are fully informed that the products:

- are not insured by the FDIC;
- are not deposits or other obligations of the institution and are not guaranteed by the institution; and,
- are subject to investment risks, including possible loss of the principal invested.

Moreover, sales activities involving these investment products should be designed to minimize the possibility of customer confusion and to safeguard the institution from liability under the applicable anti-fraud provisions of the federal securities laws, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of securities.

The four federal banking agencies -- the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision -- are issuing this Statement to provide uniform guidance to depository institutions engaging in these activities.[1]

SCOPE

This Statement applies when retail recommendations or sales of nondeposit investment products are made by:

- employees of the depository institution;

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[1] Each of the four banking agencies has in the past issued guidelines addressing various aspects of the retail sale of nondeposit investment products. OCC Banking Circular 274 (July 19, 1993); FDIC Supervisory Statement FIL-71-93 (October 8, 1993); Federal Reserve Letters SR 93-35 (June 17, 1993), and SR 91-14 (June 6, 1991); OTS Thrift Bulletin 23-1 (Sept. 7, 1993). This Statement is intended to consolidate and make uniform the guidance contained in the various existing statements of each of the agencies, all of which are superseded by this Statement.

Some of the banking agencies have adopted additional guidelines covering the sale of certain specific types of instruments by depository institutions, i.e., obligations of the institution itself or of an affiliate of the institution. These guidelines remain in effect except where clearly inapplicable.

- employees of a third party, which may or may not be affiliated with the institution,[2] occurring on the premises of the institution (including telephone sales or recommendations by employees or from the institution's premises and sales or recommendations initiated by mail from its premises); and
- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

These guidelines generally do not apply to the sale of nondeposit investment products to non-retail customers, such as sales to fiduciary accounts administered by an institution.[3] However, as part of its fiduciary responsibility, an institution should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to the institution's fiduciary customers.

ADOPTION OF POLICIES AND PROCEDURES

Program Management. A depository institution involved in the activities described above

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[2] This Statement does not apply to the subsidiaries of insured state nonmember banks, which are subject to separate provisions, contained in 12 CFR 337.4, relating to securities activities. For OTS-regulated institutions that conduct sales of nondeposit investment products through a subsidiary, these guidelines apply to the subsidiary. 12 CFR 545.74 also applies to such sales. Branches and agencies of U.S. foreign banks should follow these guidelines with respect to their nondeposit investment sales programs.

[3] Restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, are set out in 12 CFR 9.12. Similar restrictions on transactions between funds held by a federal savings association as fiduciary and any person or organization with whom there exists an interest that might affect the best judgment of the association acting in its fiduciary capacity are set out in 12 CFR 550.10.

for the sale of nondeposit investment products to its retail customers should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the features of the institution's program and addressing, at a minimum, the concerns described in this Statement. The written statement should address the scope of activities of any third party involved, as well as the procedures for monitoring compliance by third parties in accordance with the guidelines below. The scope and level of detail of the statement should appropriately reflect the level of the institution's involvement in the sale or recommendation of nondeposit investment products. The institution's statement should be adopted and reviewed periodically by its board of directors. Depository institutions are encouraged to consult with legal counsel with regard to the implementation of a nondeposit investment product sales program.

The institution's policies and procedures should include the following:

- **Compliance procedures**. The procedures for ensuring compliance with applicable laws and regulations and consistency with the provisions of this Statement.
- **Supervision of personnel involved in sales**. A designation by senior managers of specific individuals to exercise supervisory responsibility for each activity outlined in the institution's policies and procedures.
- **Types of products sold**. The criteria governing the selection and review of each type of product sold or recommended.
- **Permissible use of customer information**. The procedures for the use of

information regarding the institution's customers for any purpose in connection with the retail sale of nondeposit investment products.

- **Designation of employees to sell investment products.** A description of the responsibilities of those personnel authorized to sell nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program; and a description of any appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each class of personnel.

Arrangements with Third Parties. If a depository institution directly or indirectly, including through a subsidiary or service corporation, engages in activities as described above under which a third party sells or recommends nondeposit investment products, the institution should, prior to entering into the arrangement, conduct an appropriate review of the third party. The institution should have a written agreement with the third party that is approved by the institution's board of directors. Compliance with the agreement should be periodically monitored by the institution's senior management. At a minimum, the written agreement should:

- describe the duties and responsibilities of each party, including a description of permissible activities by the third party on the institution's premises, terms as to the use of the institution's space, personnel, and equipment, and compensation arrangements for personnel of the institution and the third party.
- specify that the third party will comply with all applicable laws and

regulations, and will act consistently with the provisions of this Statement and, in particular, with the provisions relating to customer disclosures.

- authorize the institution to monitor the third party and periodically review and verify that the third party and its sales representatives are complying with its agreement with the institution.
- authorize the institution and the appropriate banking agency to have access to such records of the third party as are necessary or appropriate to evaluate such compliance.
- require the third party to indemnify the institution for potential liability resulting from actions of the third party with regard to the investment product sales program.
- provide for written employment contracts, satisfactory to the institution, for personnel who are employees of both the institution and the third party.

GENERAL GUIDELINES

1. Disclosures and Advertising

The banking agencies believe that recommending or selling nondeposit investment products to retail customers should occur in a manner that assures that the products are clearly differentiated from insured deposits. Conspicuous and easy to comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured deposits are understood.

Content and Form of Disclosure. Disclosures with respect to the sale or recommendation of these products should, at a minimum, specify that the product is:

- not insured by the FDIC;
- not a deposit or other obligation of, or guaranteed by, the depository institution;
- subject to investment risks, including possible loss of the principal amount invested.

The written disclosures described above should be conspicuous and presented in a clear and concise manner. Depository institutions may provide any additional disclosures that further clarify the risks involved with particular nondeposit investment products.

Timing of Disclosure. The minimum disclosures should be provided to the customer:

- orally during any sales presentation;
- orally when investment advice concerning nondeposit investment products is provided;
- orally and in writing prior to or at the time an investment account is opened to purchase these products; and
- in advertisements and other promotional materials, as described below.

A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures. For investment accounts established prior to the issuance of these guidelines, the institution should

consider obtaining such a signed statement at the time of the next transaction.

Confirmations and account statements for such products should contain at least the minimum disclosures if the confirmations or account statements contain the name or the logo of the depository institution or an affiliate.[4] If a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account, and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction.

Advertisements and Other Promotional Material. Advertisements and other promotional and sales material, written or otherwise, about nondeposit investment products sold to retail customers should conspicuously include at least the minimum disclosures discussed above and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance. The minimum disclosures should also be emphasized in telemarketing contacts. Any third party advertising or promotional material should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller. If brochures, signs, or other written material contain information about both FDIC-insured deposits and nondeposit investment products, these materials should clearly segregate information about nondeposit investment products from the

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[4] These disclosures should be made in addition to any other confirmation disclosures that are required by law or regulation. E.g., 12 CFR Parts 12 and 344, and 12 CFR 208.8(k)(3).

information about deposits.

Additional Disclosures. Where applicable, the depository institution should disclose the existence of an advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution and any material relationship between the institution and an affiliate involved in providing nondeposit investment products. In addition, where applicable, the existence of any fees, penalties, or surrender charges should be disclosed. These additional disclosures should be made prior to or at the time an investment account is opened to purchase these products.

If sales activities include any written or oral representations concerning insurance coverage provided by any entity other than the FDIC, e.g., the Securities Investor Protection Corporation (SIPC), a state insurance fund, or a private insurance company, then clear and accurate written or oral explanations of the coverage must also be provided to customers when the representations concerning insurance coverage are made, in order to minimize possible confusion with FDIC insurance. Such representations should not suggest or imply that any alternative insurance coverage is the same as or similar to FDIC insurance.

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the depository institution. Recommending or selling a nondeposit investment product with a name similar to that of the depository institution should only occur pursuant to a sales program designed to minimize the risk of

customer confusion. The institution should take appropriate steps to assure that the issuer of the product has complied with any applicable requirements established by the Securities and Exchange Commission regarding the use of similar names.

2. Setting and Circumstances

Selling or recommending nondeposit investment products on the premises of a depository institution may give the impression that the products are FDIC-insured or are obligations of the depository institution. To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. However, in the limited situation where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place to minimize customer confusion.

In no case, however, should tellers and other employees, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer customers to individuals who are specifically designated and trained to assist customers interested in the

purchase of such products.

3. Qualifications and Training

The depository institution should ensure that its personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of customer protection requirements. If depository institution personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives.[5] Depository institution personnel with supervisory responsibilities should receive training appropriate to that position. Training should also be provided to employees of the depository institution who have direct contact with customers to ensure a basic understanding of the institution's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to customer referrals. Training should be updated periodically and should occur on an ongoing basis.

Depository institutions should investigate the backgrounds of employees hired for their nondeposit investment products sales programs, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry

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[5] Savings associations are not exempt from the definitions of "broker" and "dealer" in Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934; therefore, all securities sales personnel in savings associations must be registered representatives.

experience.

4. **Suitability and Sales Practices**

Depository institution personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if depository institution personnel recommend nondeposit investment products to customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically.

5. **Compensation**

Depository institution employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referral for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in

unsuitable recommendations or sales being made to customers.

Depository institution compliance and audit personnel should not receive incentive compensation directly related to results of the nondeposit investment sales program.

6. Compliance

Depository institutions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations, the institution's internal policies and procedures, and in a manner consistent with this Statement. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third party sales are being conducted in a manner consistent with the governing agreement with the depository institution.

The compliance function should be conducted independently of nondeposit investment product sales and management activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported directly to the institution's board of directors, or to a designated committee of the board. Appropriate procedures for the nondeposit investment product program should also be incorporated into the institution's audit program.

SUPERVISION BY BANKING AGENCIES

The federal banking agencies will continue to review a depository institution's policies and procedures governing recommendations and sales of nondeposit investment products, as well as management's implementation and compliance with such policies and all other applicable requirements. The banking agencies will monitor compliance with the institution's policies and procedures by third parties that participate in the sale of these products. The failure of a depository institution to establish and observe appropriate policies and procedures consistent with this Statement in connection with sales activities involving nondeposit investment products will be subject to criticism and appropriate corrective action.

Questions on the Statement may be submitted to:

FRB -- Division of Banking Supervision and Regulation, Securities Regulation Section, (202) 452-2781; Legal Division, (202) 452-2246.

FDIC -- Office of Policy, Division of Supervision, (202) 898-6759; Regulation and Legislation Section, Legal Division (202) 898-3796.

OCC -- Office of the Chief National Bank Examiner, Capital Markets Group, (202) 874-5070.

OTS -- Office of Supervision Policy, (202) 906-5740; Corporate and Securities Division, (202) 906-7289.

Richard Spillenkothen
Director, Division of Banking
Supervision & Regulation
Federal Reserve Board

Stanley J. Poling
Director, Division of Supervision
Federal Deposit Insurance Corporation

Susan F. Krause
Senior Deputy Comptroller for
Bank Supervision Policy
Office of the Comptroller of the
Currency

John C. Price
Acting Assistant Director for Policy
Office of Thrift Supervision

EFFECTIVE DATE: February 15, 1994

ATTACHMENT "B"

12 C.F.R. 5.34

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

Interpretive Letter No. 622
May 1993

April 9, 1993

Mr. Paul J. Polking
NationsBank Corporation
Legal Department
NationsBank Corporate Center
Charlotte, North Carolina 28255-0065

Re: NationsBank of North Carolfna, N.A.
Operating Subsidiary Notice; Control Number 92 ML08010

Dear Mr. Polking:

This letter responds to the notification filed on October 26, 1992, on behalf of NationsBank of North Carolina, N.A. ("Bank") pursuant to 12 C.F.R. § 5.34, of the Bank's intent to establish a wholly-owned operating subsidiary ("Subsidiary") to participate, as a general partner, in a proposed general partnership ("Partnership") with a subsidiary of Dean Witter Financial Services Group ("DW"). The Partnership will be created pursuant to a joint venture agreement ("Joint Venture") between the Bank and DW relating to the sale, on a retail basis through the partnership of various types of investment products, including securities and annuities.

Based on the information and representations in the Bank's notification letter, accompanying legal memorandum, supplemental documentation, and other materials, we conclude that the proposed activities are permissible for national banks and their operating subsidiaries and are consistent with prior opinions of the Office of the Comptroller of the Currency ("OCC"). Accordingly, the Bank may implement its proposal pursuant to 12 C.F.R. § 5.34, based on the facts as described and in accordance with all the representations made in the submitted materials. This determination also subjects the Bank, the Subsidiary, and the Partnership to all the conditions set forth in this letter.

<u>The Bank's Proposal</u>

Under the proposal, the Bank's Subsidiary and a newly established subsidiary of DW will enter into a general partnership, each with a fifty (50%) percent interest. The Partnership will be a separate and distinct entity from the Bank, DW, and their affiliates. The Partnership will not provide or permit access to a partner of confidential and proprietary information received

from the other partner or any of its affiliates.[1] As such, DW will not have direct access to Partnership customers.

The day-to-day business of the Partnership will be managed by a chief operating officer who will have the authority to make decisions within operating guidelines set forth in the Partnership agreement. The initial chief operating officer will be a former senior officer of DW or an affiliate thereof, and the next ranking officer will be a former senior officer of NationsBank Corporation ("NBC") or a subsidiary thereof. The chief operating officer and next ranking officer will completely sever their previous employment relationships with DW or its affiliates, and the Bank or its affiliates, respectively. These individuals will be employed exclusively by the Partnership.[2] The Partnership agreement will specify that all major decisions of the Partnership and any changes in the operating guidelines must be approved by both Partners. Each partner in effect has veto power over actions proposed by the other partner. Accordingly, the Subsidiary could not be precluded by the other partner from having the Partnership's operations and activities conform to the national banking laws, including any condition imposed pursuant to 12 C.F.R. § 5.34.

The Partnership agreement will fully delineate the activities of the Partnership, which activities will be limited to those permissible for a national bank or its operating subsidiary. Further, the Partnership agreement will provide that the Partnership will be subject to full OCC regulation, supervision and examination, including an undertaking by the Partnership to cease engaging in any activity which the OCC formally determines not to be permissible. While the Partnership contemplates an initial five year term, certain events, such as an adverse regulatory decision, could trigger an earlier termination of the Partnership. Under the submitted proposal, the Partnership will not own or control any subsidiaries. If the Partnership intends or proposes such ownership or control of subsidiaries in the future then the OCC would require the submission of a notice pursuant to 12 C.F.R. § 5.34.

The proposed name of the Partnership is "Nations Securities, a Dean Witter/NationsBank Company." The principal executive office

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[1] Customer lists of the Partnership also will be accorded confidential treatment by the Partners, including DW, and, except for customers who have a relationship with a Partner or its affiliate outside of the Partnership, will not be provided by a Partner to any affiliate or other third party other than in connection with services provided to the Partnership.

[2] We understand that this also will be true of any other employees of the Partnership previously employed by the Bank, DW or their affiliates.

of the Partnership will be located in Charlotte, North Carolina,[3] however, the Partnership will establish offices at other NBC locations, including branch offices of bank subsidiaries of NBC, and other locations. The Bank has assured us that various efforts will be made by the Partnership to promote separateness between the Bank's operations and those of the Partnership. In particular, the Bank has represented that the Partnership office typically will be segregated by panels, planters, walls or similar physical elements. Each Partnership office will be separately identified as an office of the Partnership through appropriate signs, which will include the Partnership's name and logo. The Partnership's logo will be distinct from the logo of the Bank. The Partnership also will have different telephone numbers.

The Partnership will be registered as a broker/dealer under the Securities Exchange Act of 1934 ("Act") and under applicable state securities laws. The Partnership also will be a member of the National Association of Securities Dealers, Inc. ("NASD") and a licensed insurance agent to sell fixed and variable annuities in states where so required.[4] The Partnership will be subject to all applicable requirements of the federal securities laws and the Rules of Fair Practice of the NASD.

Proposed Activities of the Partnership

The Bank Program

The business of the Joint Venture will consist initially of the Bank Program and subsequently of the Syndication Program. The Bank Program will consist of sales, entirely on an agency basis, to existing customers and new customers of the Bank and DW or their subsidiaries.[5] The brokerage activities of the

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[3] The Subsidiary's principal office also will be located in Charlotte, North Carolina.

[4] The Bank states that the Partnership will not be registered as an investment advisor under the Investment Advisors Act of 1940, as the advice provided by the Partnership will be incidental to the conduct of its brokerage business and the Partnership will not receive special compensation for providing such advice. See 15 U.S.C. § 80b-2(a)(11).

[5] The Bank represents that the Partnership will not act as a "principal" in connection with any investment products. However, as part of its brokerage activities, the Partnership may engage in so-called "riskless principal" transactions, whereby the Partnership on behalf of a customer may effect the purchase and sale of a security on a principal basis but only if it can conduct a concurrent offsetting sale and purchase of the same security with another party. In no event will the Partnership

Partnership will involve primarily the sale of "packaged products," such as mutual funds, fixed and variable annuities,[6] unit investment trusts, and equity and fixed income securities. The mutual funds sold will include funds advised by the Bank and its affiliate banks,[7] mutual funds sponsored, distributed and advised by DW and its affiliates, and mutual funds sponsored, distributed and advised by parties not affiliated with either the Bank or DW. The compensation received by the Partnership for its brokerage activities will be consistent with that customarily received by an agent and not that of a principal or dealer. Nor will Bank employees receive direct compensation for referring customers to the Partnership based upon completed sales.

The Partnership also may provide investment advice to customers in connection with the purchase and sale of the investment products. The ultimate investment decision, however, will rest exclusively with the customer. The Partnership will not have any accounts over which it has discretionary authority. The Partnership may, in a manner consistent with all applicable rules governing broker/dealers in such circumstances, recommend or suggest certain mutual funds. If it is the case with any such recommended mutual fund, customers will be advised that the Bank or an affiliate is the advisor to the mutual fund.

In addition, the Bank has represented that the Partnership will not provide brokerage services to the Bank's trust account customers or Bank customers with other fiduciary relationships, except where explicitly authorized by the customer and in accordance with all applicable laws, including the applicable provisions of 12 C.F.R. Part 9 and interpretations thereunder. Further, if the Partnership provides any services to Keogh accounts, self-directed individual retirement accounts, or other similar accounts of the Bank, such activities will be consistent with prior OCC precedents requiring specific customer authorization and full disclosure of the arrangements, including fees or commissions. See Trust Interpretive Letter No. 88 (March 24, 1987); Interpretive Letter No. 302 (February 21, 1984), reprinted in [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,472. We also remind the Bank of its fiduciary obligations under state law and pursuant to the OCC's self-dealing regulation, 12 C.F.R. § 9.12, which reflects a trustee's duty of

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maintain an account for the purchase and sale of securities on its own behalf or initiate an order or hold the securities for its own account.

[6] The fixed and variable annuities sold may be issued/underwritten by an insurance company affiliated with DW, although unaffiliated with the Subsidiary or the Bank.

[7] The funds are sponsored and distributed by an independent party.

loyalty, a basic principle of trust law. As such, the Bank must carefully consider all applicable laws with respect to the purchase in a fiduciary capacity of any products underwritten by DW or other products in which DW has an interest.

The Partnership will provide full disclosure to insure that customers who purchase on bank premises are not confusing the investment products with insured deposits. The information provided by the Partnership will advise customers that the products are not endorsed or guaranteed by, and do not constitute obligations of, the Partnership, the Subsidiary, the Bank, or their affiliates, and that the products are not insured by the Federal Deposit Insurance Corporation ("FDIC"). The Partnership also will provide disclosure to customers explaining the relationship of the Partnership and the products that it sells, to the Bank and its affiliates and to DW and its affiliates. The Bank has represented that customers will receive these disclosures in several ways, including (1) disclosures built into the customer account agreements or additional disclosure documents provided when the customer relationship is initiated; (2) in connection with a particular product, disclosures in the prospectus, sales literature, or other materials;[8] (3) verbal disclosures and explanations by the sales staff;[9] and (4) confirmations to customers of the securities transactions in accordance with securities laws.

In particular, with respect to mutual funds, customers will be fully informed if the Bank or an affiliate is an advisor to a fund or if DW or an affiliate is a sponsor/distributor or advisor to a fund. Similarly, regarding annuities, customers will be fully informed if the products are issued or underwritten by a company affiliated with DW or an affiliate. Similar to recent OCC precedents relating to annuities activities, as a condition of this approval, a signed statement will be obtained from a customer prior to the purchase of any non-deposit investment product indicating that the customer understands the nature of the investment product being purchased. See Interpretive Letter No. 499 (February 12, 1990), reprinted in [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,090.

The Bank has described various plans which may be put into effect

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[8] In addition, the Bank has represented that internal policies and procedures concerning appropriate disclosures may be adopted with respect to particular products.

[9] If the Partnership determines to recommend any DW or Bank product in which either has a financial interest, the Bank has given assurances that the Partnership representative will be mindful of suitability requirements and will confirm that the nature of the financial interest of DW or the Bank in such products has been disclosed to the customer.

to market the Partnership's services. These include making lobby materials on the Partnership available to Bank customers; putting advertisements in newspapers; sending statement stuffers; and providing other descriptions of the variety of services that are available. The Bank points out that these marketing tools are the same as those currently in use by the Bank's brokerage subsidiary, NationsBank Securities, Inc. ("NSI"), and will be in conjunction with all the disclosures and representations previously discussed. All such marketing activities by the Partnership and any by the Bank would seek to minimize the possibility of customer confusion with respect to the products being offered and the relationship between the entities. For example, all sales materials will clearly describe the relationship between the Partnership, the Bank, and DW and its affiliates. Further, the confidentiality requirements between the involved entities and the restrictions of the sharing of customer lists will apply. The Bank has indicated that it does not plan on specific references to DW products in the materials describing the Partnership and, instead, emphasizes that its marketing will focus on the Partnership rather than DW.

The Bank has represented that the Partnership will not be deemed an underwriter or dealer within the meaning of any provision of the federal securities laws.[10] The Partnership is prohibited from acting as a sponsor or distributor of any of the mutual funds it sells as agent. Moreover, the Partnership will have no obligation to sell any securities which DW or any of its affiliates underwrite or participate in underwriting in any way, serve as a market maker in, or hold in any principal position.[11] With respect to securities underwritten by DW or its affiliates, the Partnership will not participate in any underwriting activities, or act as a selling group member, and will only act in the same capacity as any other broker/dealer not engaged in the underwriting. While it is contemplated that DW or an affiliate will provide the Partnership certain clearing services, these services will be of a type customarily provided by a clearing broker and consistent with general brokerage industry practices. The Partnership and the DW affiliate acting as clearing broker, as registered broker/dealers, will be subject to the requirements of the federal securities laws, as well as the Rules of Fair Practice of the NASD, regarding their respective activities.

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[10] This includes being deemed a "principal underwriter" under the Investment Company Act of 1940 of any mutual fund it sells because the Bank represents that the Partnership will not be in privity of contract with any mutual fund. <u>See</u> 15 U.S.C. § 80a-2(a)(29).

[11] Bank counsel has represented that DW currently engages predominantly in retail brokerage and only conducts limited underwriting activities.

The Syndication Program

The Partnership also plans on entering into arrangements with other unaffiliated depository institutions in the future to operate essentially a third-party managed securities and annuities program at the branch locations of those depository institutions. The Syndication Program will involve generally the same brokerage and investment advice activities as described above in connection with the Bank Program. All activities in connection with the Syndication Program will be permissible for national banks and their subsidiaries. Clear identification and disclosure will be made to customers that the Partnership and the depository institution are separate businesses, that the employees of the Partnership are not employees of the depository institution, that the products being offered are not obligations of the institution and are not FDIC insured. In addition, the same disclosures with respect to the Bank Program discussed above will be made to customers concerning the relationship of the Partnership, the Bank, or DW, to the products themselves.

As in leasing arrangements previously approved by the OCC with unaffiliated tenants, the Partnership contemplates leasing space at branch locations of these depository institutions on a "gross receipts" basis. In the event the Partnership intends to engage in any new activities with respect to the Syndication Program, the OCC would require submission of a notice pursuant to 12 C.F.R. § 5.34.

We understand that the operations of the Bank, the Subsidiary, and the Partnership will be conducted in accordance with all applicable laws and regulations. The Bank, the Subsidiary, and the Partnership also will be expected to conduct these activities in a prudent manner, consistent with safe and sound banking practices.

Discussion

National banks may choose to engage in activities which are part of or incidental to banking by means of an operating subsidiary. See 12 C.F.R. § 5.34(c). The activities to be conducted by the Subsidiary through the Partnership are permissible banking and securities activities and are consistent with previous opinions of the OCC.

It is well-established that national banks and their subsidiaries may perform brokerage services for their customers. See e.g., Securities Industry Association v. Comptroller of the Currency, 557 F. Supp. 252 (D.D.C. 1983), aff'd per curiam, 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986) (brokerage issue), rev'd, 479 U.S. 388 (1987) (branching issue) ("Security Pacific"). The Glass Steagall Act ("GSA") permits securities brokerage activities by national banks including the purchase and/or sale, as agent, of shares in mutual funds, units in unit

investment trusts, or annuities.[12] See e.g. Interpretive Letter No. 499 (February 12, 1990), reprinted in [1989-90 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,090; Interpretive Letter No. 403 (December 9, 1987), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,627; Interpretive Letter No. 386 (June 19, 1987), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,610; Interpretive Letter No. 363 (May 23, 1986), reprinted in [1985-87 Transfer Binder], Fed. Banking L. Rep. (CCH) ¶ 85,533. Moreover, the OCC has permitted bank operating subsidiaries to engage in riskless principal brokerage. See Interpretive Letter No. 371 (June 13, 1986), reprinted in Fed. Banking L. Rep. (CCH) ¶ 85,541. The combination of investment advice and brokerage services in the same subsidiary also has been previously approved by the OCC. See e.g., Interpretive Letter No. 403, supra; Interpretive Letter No. 386, supra.

The conduct of these activities for national banks through a partnership structure also is permissible. In prior instances, the OCC has permitted the subsidiary of a national bank to enter into a general partnership with another general partner, so long as the partnership will engage only in activities that are permissible for a national bank. See e.g., Interpretive Letter No. 516 (July 12, 1990), reprinted in [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,220; Interpretive Letter No. 411 (January 20, 1988), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,635; Interpretive Letter No. 289 (May 15, 1984), [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,453. Moreover, the OCC has not objected to operating subsidiary notices involving joint venture/partnership proposals between national bank subsidiaries and subsidiaries of investment banks. See Interpretive Letter No. 516, supra; OCC Letter from J. Michael Shepherd to Kenneth L. Bachman, Jr. (March 26, 1990); Interpretive Letter No. 411, supra. As in these earlier letters, the partnership structure poses no problems provided certain conditions are met. See id.

As discussed in detail in earlier letters involving partnerships between bank operating subsidiaries and investment banks or

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[12] As you know, however, insurance industry trade groups have filed suit in federal court challenging the OCC's approval of the sale of fixed rate annuities by national bank operating subsidiaries. See Variable Annuity Life Insurance Co. [VALIC] v. Clarke, 786 F. Supp. 639 (S.D. Tex. 1991); National Association of Life Underwriters v. Clarke, 761 F. Supp. 1285 (W.D. Tex. 1991). While the lower court decision in VALIC upheld the OCC's approval, this case presently is on appeal. The final resolution of this litigation could result in a different outcome and possibly affect the Partnership's ability to engage is such activities.

subsidiaries thereof, and analogous here, the proposed Partnership would not be prohibited by section 20 of the Glass-Steagall Act, 12 U.S.C. § 377, or section 32 of the Act, 12 U.S.C. § 78. See Interpretive Letter No. 516, supra; Interpretive Letter No. 411, supra. Section 20 provides that a member bank shall not be affiliated in any manner described in 12 U.S.C. § 221a with a business organization engaged principally in the issue, flotation, underwriting, public sale or distribution of securities. Assuming arguendo that DW is so engaged, since no affiliation under section 221a will occur, the proposed Partnership would not cause the Bank to become affiliated with DW or its subsidiaries in any manner prohibited by section 20. Section 32 provides that no officer, director, or employee of any business organization primarily engaged in the issue, flotation, underwriting, public sale or distribution of securities shall serve at the same time as an officer, director or employee of a member bank. Under the proposed Partnership, no Bank officer, director or employee will serve as such in the parent investment bank and no investment bank officer, director or employee will serve as such in the Bank; thus, there are no prohibited relationships. See id.

While certain Partnership employees previously may have been employees of the Bank, DW, or their affiliates, the Bank has represented that no Partnership employees will concurrently be directors, officers, or employees of either the Bank, DW, or their respective affiliates. The OCC has taken the position that a partnership's management and staff are not ordinarily attributed to the parent firms of the business entities involved. See id.

The Syndication Program feature of the Bank's proposal also is permissible for national banks and their operating subsidiaries under the facts described. The OCC has approved percentage leasing where an unaffiliated tenant makes its services or products available, through its own employees, on bank premises. See e.g., Interpretive Letter No. 533 (October 5, 1990), reprinted in [1990-91 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,244; Interpretive Letter No. 406 (August 4, 1987), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,630. The Partnership will conduct the Syndication Program's activities in accordance with previous precedents and will maintain the Partnership's operations separate from those of the other unaffiliated depository institutions.

Further, the Bank's proposal is consistent with branching limitations on national banks. See 12 U.S.C. § 36; Securities Industry Association v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), aff'd per curiam, 758 F.2d 739 (D.C. Cir 1985), cert. denied, 474 U.S. 1054 (1986)(brokerage), rev'd, 479 U.S. 388 (1987)(branching). While the Partnership need not limit its brokerage activities to its parent bank's branch locations, to the extent the Partnership is required to perform any activity

at a bank branch location, it represents that it will do so.

While the OCC has carefully considered the potential for customer confusion or misunderstanding inherent in the Bank's proposal, the Bank has provided that multiple opportunities will exist for the appropriate disclosures to customers concerning the nature of the products being sold and the relationship of the involved entities to the products. Specifically, the Bank has represented that disclosures on mutual funds and annuities will conform with those required in previous OCC opinions. The conditions relating to disclosures to customers and compliance with state laws imposed in the recent letters are, likewise, imposed on the Partnership as well as the Bank and its operating subsidiary.[13] See e.g., Letter from J. Michael Shepherd, Senior Deputy Comptroller for Corporate and Economic Programs (March 20, 1990) (fixed and variable annuities); Interpretive Letter No. 403, supra (mutual funds and unit investment trusts); see also Letter from William P. Bowden, Jr., Chief Counsel (October 14, 1992).

Given the nature of the joint venture proposed by the Bank, the OCC is particularly concerned that bank customers understand that products being offered or recommended by the Partnership are uninsured, not obligations of the Bank or the Partnership, and not deposit substitutes and that in some instances the Bank or DW or their affiliates may have a relationship to and a financial interest in the products themselves. The OCC cautions the Partnership to use special care in ensuring that the interests of customers are protected and that customers are able to evaluate any potential conflicts of interest that may exist when a DW product is sold or recommended. As stated earlier, the Bank has represented that the Partnership will comply with all applicable disclosure requirements under the federal securities laws, the Rules of Fair Practice of the NASD, previous OCC precedents, and any state securities laws requirements.

The Partnership's activities are permitted subject to the conditions and representations as provided in this letter and based on the Bank's assurances that full and adequate information will be provided to the Partnership's customers to ensure full disclosure of the relationship with DW when the Partnership recommends a DW product. Please be advised that if compliance difficulties arise related to this activity (including any evidence that customers were unaware of or did not understand the relationships involved), the OCC may impose additional limitations on the Partnership's activities with respect to DW

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[13] These conditions are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818.

products.

Supervisory Conditions

The OCC's approval of the Bank's operating subsidiary notice is subject to the following conditions, in addition to the representations and conditions specified in your notification letter and other materials:

(1) The Partnership shall disclose to customers at the time an account is established that the investment products offered by the Partnership (a) are not FDIC insured; (b) are not obligations of the Bank or the Partnership; (c) are not guaranteed by the Bank or the Partnership; and (d) involve investment risks, including possible loss of principal. These disclosures shall be provided using the above language or substantially similar language. The Partnership shall also obtain at the time an account is established a signed statement acknowledging that the customer has received and understands the above disclosures.

(2) The disclosures described in condition (1) above also must be conspicuously disclosed to customers in all written sales presentations, advertising and promotional materials, confirmation forms, and periodic statements.

(3) The Partnership shall provide full disclosure to customers at the time an account is established explaining the relationships between the Partnership, the Bank, and DW, and the products sold by the Partnership, and also shall disclose that from time to time the products offered by the Partnership may involve entities having other relationships, including lending relationships with the Bank and DW.

(4) The Partnership may not offer uninsured investment products with a name identical to the Bank. The Partnership's products may not be marketed in a manner that would mislead or deceive consumers as to the products' uninsured nature and lack of any guarantee by the Bank or the Partnership.

(5) The Partnership will maintain an operations manual and other written materials addressing the conduct of retail sales activities of the Partnership, which will be made available for OCC review. Customer suitability judgment procedures and compliance with 12 C.F.R. Part 9 conflict of interest prohibitions should be emphasized.

(6) The Subsidiary will be adequately capitalized.

(7) The Partnership will be managed to minimize the risk of piercing the corporate veil.

(8) The Partnership agreement will fully delineate the activities of the Partnership.

(9) The Bank, through the Subsidiary, will have veto power over the activities of the Partnership and its major decisions.

(10) The Partnership will be subject to OCC regulation, supervision and examination.

(11) The Bank's aggregate direct and indirect investments in and advances to the Subsidiary and the Partnership shall not exceed an amount equal to the Bank's legal lending limit.[14]

(12) The Bank must submit a notice to us pursuant to 12 C.F.R. § 5.34 if the Partnership at some future time decides to engage in new activities, i.e. activities not covered by your current notice and our response thereto. This submission must be made even though the activities have been found to be permissible for national banks.

Please be advised that the conditions of this approval are deemed to be "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. § 1818.

<u>Conclusion</u>

Subject to the representations and conditions specified in your notification letter and other submitted materials, as well as those in this response, the Bank may proceed with its proposal. This response is based solely on the facts as represented and any changes in the facts might require a different result. Our analysis also reflects current legal and prudential standards, and may be subject to revision as future developments warrant.

Sincerely,

Frank Maguire

Frank Maguire
Acting Senior Deputy Comptroller
Corporate Policy and Economic Analysis

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[14] Neither the Bank nor the Partnership will be obligated or committed to extend credit to any customer of the Partnership for purposes of purchasing any product through the Partnership. All credit so extended will be on an arm's length basis and consistent with safe and sound banking.

ATTACHMENT "C"

NEWS RELEASE

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

NR 94-23

For: IMMEDIATE RELEASE

Contact: (202) 874-4700

Date: February 24, 1994

COMPTROLLER ISSUES GUIDANCE TO EXAMINERS ON MUTUAL FUND SALES

The Office of the Comptroller of the Currency (OCC) today released procedures for examining the mutual fund or other retail nondeposit investment sales operations of national banks. The guidance implements the statement on nondeposit investment products issued by the federal bank and thrift regulators last week.

"Today's action is the result of draft exam procedures that our examiners have been field testing for the past six months. All OCC examiners will now have detailed guidance about how to examine bank mutual fund sales," said Comptroller of the Currency Eugene A. Ludwig. "I'm instructing examiners to determine that bank management responds immediately to any matter that has the potential to confuse customers as to the uninsured nature of nondeposit investment products."

The examination procedures cover all aspects of a national bank's retail sales activities, including sales made by bank employees and sales on bank premises made by employees of third party vendors. The procedures are more detailed than the OCC's previous guidance and offer specific examples of what the OCC expects from national banks that engage in this business.

Among other things, the procedures instruct examiners to:

- Criticize sales programs with fund names so similar to the bank's that even mitigating circumstances are unlikely to eliminate customer confusion. For example, a bank named First National Bank would be misleading customers if it operated an uninsured fund called First National Bank Fund.

- Increase scrutiny of ALL aspects of a bank's sales program if the bank's name is greatly similar to the fund's name.

- more -

- Assess the independence and thoroughness with which banks select the products they will offer. In particular, examiners should criticize bank managers who choose investment products simply because they generate the largest sales fees.

- Verify that banks with investment sales programs have disclosed that mutual funds and other nondeposit investment products (1) are not FDIC insured, (2) are not deposits or other obligations or guarantees of the bank, and (3) involve investment risks, including possible loss of principal amount invested.

- Determine whether these disclosures are featured conspicuously in all written or oral sales presentations, advertising and promotional materials, confirmations, and periodic statements that include the name or the logo of the bank or an affiliate. The procedures state that disclosures in advertisements and brochures should appear in text at least as large as that describing the product. The OCC will consider disclosures to be conspicuous if they are on brochure covers or at the front of descriptive text.

- Determine whether products recommended for sale are suitable investments for customers. In particular, the procedures call for special attention for product recommendations made to first-time, risk averse, elderly, or surviving spouse customers.

- Verify that a bank has assigned a bank officer to be responsible for resolving any customer complaints.

The procedures also include other examples of steps banks can take to minimize customer confusion. For example, they give advice about how banks can ensure that sales personnel are giving accurate disclosures to customers by using "testers." They also have guidance on oversight of third party vendors selling on bank premises and describe techniques used by well-managed banks to select mutual funds or other investment products, such as annuities, for sale to the bank's customers.

The OCC will send copies of the examination procedures to all national banks and all national bank examiners.

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OCC 94-13

OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Nondeposit Investment Sales Examination Procedures

Description: Temporary Insert — *Handbook for National Bank Examiners*

TO: All Users of the *Comptroller's Handbook for National Bank Examiners*

PURPOSE

This issuance transmits a new section 413, Retail Nondeposit Investment Sales, for the *Comptroller's Handbook for National Bank Examiners*. This section should be inserted in the handbook at the end of the "Other Areas of Examination Interest" section, behind section 412, Discount Brokerage Activity.

REFERENCES

Banking Circular 274, Retail Nondeposit Investment Sales, is rescinded and replaced by new section 413 to the *Comptroller's Handbook for National Bank Examiners*, dated February 1994, attached.

BACKGROUND

On July 19, 1993, the Office of the Comptroller of the Currency issued Banking Circular 274, Retail Nondeposit Investment Sales, which provided guidelines for national banks involved in the sale to retail customers of mutual funds, annuities, and other nondeposit investments. Those guidelines were superseded on February 15, 1994, by the issuance of an Interagency Statement, developed by the OCC, the Federal Reserve Board, the FDIC, and the OTS. The Interagency Statement will apply uniform standards to federally insured financial institutions offering these services.

SCOPE

The Interagency Statement is incorporated in this insert, which provides national bank examiners with procedures for examining the nondeposit investment sales activities of national banks. The questions and procedures presented here check for compliance with the Interagency Statement as well as laws, rules, and regulations. They also provide national bank examiners with a basis for evaluating management and controls in this type of operation.

Date: February 24, 1994

OCC 94-13

OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Nondeposit Investment Sales Examination Procedures

Description: Temporary Insert — *Handbook for National Bank Examiners*

RESPONSIBLE OFFICE

Questions concerning the Interagency Statement or any part of the insert may be directed to the Office of the Chief National Bank Examiner, Capital Markets Group, in Washington, DC at (202) 874-5070.

Susan F. Krause

Susan F. Krause
Senior Deputy Comptroller for Bank Supervision Policy

Enclosure

Retail Nondeposit Investment Sales

Introduction

Section 413.1

This section sets forth guidance for examiners reviewing bank nondeposit investment product retail sales operations, including bank-related marketing and promotional activities. Examiners will review a bank's programs for consistency with the Interagency Statement on Retail Sales of Nondeposit Investment Products, dated February 15, 1994 (Interagency Statement). The evaluation will cover all bank-related activities including:

- Sales or recommendations made by bank employees;
- Sales or recommendations made by employees of affiliated or unaffiliated entities occurring on bank premises (including sales or recommendations initiated by telephone or by mail from bank premises); and
- Sales resulting from referrals of retail customers to a third party when the bank receives a benefit for the referral.

When reviewing a bank's nondeposit investment sales operation, examiners should determine that the bank views customers' interests as critical to all aspects of its sales programs. Examiners should evaluate a bank's policies and procedures from the customers' perspective and should ascertain that customers are provided with a high level of protection. If it becomes necessary to recommend remedial action, examiners should determine that bank management responds immediately to any matter that has the potential to confuse customers as to the uninsured nature of nondeposit investment products.

Banks that do not operate programs safely and soundly or that engage in violations of law or regulations will be subject to appropriate regulatory action. When determining the appropriate action, examiners should be mindful that some banks, especially banks relying on third parties for sales of nondeposit investment products, may need time to conform their programs to the Interagency Statement and to the guidance contained herein. At a minimum, however, examiners should determine whether bank management is making a good faith effort to comply with this regulatory guidance in a timely manner.

This section applies to sales to individual customers but does not apply to the wholesale sale of nondeposit investment products to non-retail customers, such as sales to institutional customers or to fiduciary accounts administered by an institution. As part of its general responsibilities, however, a national bank should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to institutional customers or to the bank's fiduciary customers. For additional information on restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, see 12 CFR 9.12 and "Sales to Fiduciary Accounts," later in this section.

Scope

Examiner reviews of a bank's mutual fund or other nondeposit investment sales program will concentrate on the policies and procedures the bank adopts and on the effectiveness of their implementation.

When reviewing implementation of a bank's program, examiners will investigate whether senior bank management has:

(1) Participated in planning the bank's investment sales program;

(2) Adopted a framework to ensure compliance with all applicable laws, rules, regulations, regulatory conditions, and the Interagency Statement; and

(3) Ensured effective supervision of individuals engaged in sales activities, including employees of the bank and any other entity involved in bank-related sales of investment products.

Where relevant, references in this handbook section to bank management or bank employees includes third party managers or third party employees.

Minimum Standards for Nondeposit Investment Programs

Antifraud provisions of the federal securities laws prohibit materially misleading or inaccurate representation in connection with offers and sales of securities. (See, for example, Section 10 of the Securities Exchange Act of 1934 and Rule 10b-5.) If customers are misled about the nature of nondeposit investment products, including their uninsured status, sellers could face potential liability under these antifraud provisions. Safe and sound banking also requires that bank-related retail sales activities be operated to avoid confusing customers about the products being offered. Use of nonbank employees to sell these products does not relieve bank management of the responsibility to take reasonable steps to ensure that the investment sales activities meet these requirements.

The Rules of Fair Practice of the National Association of Securities Dealers (NASD) expressly govern sales of securities by broker/dealers who are members of NASD. These rules apply to bank-related securities sales by banking subsidiaries registered as broker/dealers, affiliated broker/dealers, and unaffiliated broker/dealers operating under agreements with banks. These rules apply whether such sales are made on bank premises or at a separate location.

These rules do not expressly apply to sales or recommendations made directly by the bank. Even when these rules do not expressly apply, however, they are an appropriate reference for a bank compliance program designed to ensure that the bank's retail sales of all nondeposit investment products are operated in a safe and sound manner.

Before beginning to operate a nondeposit investment sales program, banks may also consider notifying their blanket bond carriers of plans to engage in these activities. If applicable, this could permit the bank to obtain written assurances from the carrier that the bank's insurance coverage for employees includes staff representing third party vendors.

Examiners also should encourage bank management to review *Retail Investment Sales: Guidelines for Banks*. The publication, prepared jointly by six banking industry trade associations, contains voluntary guidelines for bank sales of nondeposit investment products as well as common sense suggestions for putting many of the OCC's recommendations into action.

Program Management

Banks must comply with all applicable laws, rules, regulations, and regulatory conditions, and operate consistently with the Interagency Statement for any of their bank-related retail sales of mutual funds, annuities, or other retail nondeposit investment products. Bank directors are responsible for evaluating the risks imposed by bank-related sales and are expected to adopt a program statement and self-regulatory policies and procedures to ensure compliance with all requirements. A bank's policies and procedures must address bank-related retail sales made directly by a bank, through an operating subsidiary or affiliate, or by an unaffiliated entity.

Examiners should expect that banks will tailor their policies and procedures to the scope of the bank's sales activities. The level of detail contained in a bank's policies and procedures will depend on the structure and complexity of the bank's program.

Examiners will review the bank's securities sales activities to determine that the bank has adopted a statement that addresses the risks associated with the sales program and describes the features of the sales program, the roles of bank employees, and the roles of third party entities. The statement should set forth the strategies the bank will employ to achieve its objectives. It also should outline the self-regulatory procedures bank management will implement to ensure that the program's objectives are met without compromising the customers' best interests.

Retail Nondeposit Investment Sales

Introduction

At a minimum, examiners should expect bank policies and procedures to address:

Supervision of personnel involved in nondeposit investment sales programs — Senior bank managers will be expected to ensure that specific individuals employed by the bank, an affiliated broker/dealer, or a third party vendor are responsible for each activity outlined in the bank's policies and procedures. Managers of the bank's securities sales activities will be accountable for understanding the investment products offered and the sales process, as well as for assuring compliance with securities and banking laws, rules, and regulations.

Designation of employees authorized to sell investment products — This should serve as a guide for all bank-related employees dealing with retail nondeposit investment product customers. The program statement should specify that only properly trained and supervised employees are permitted to make investment sales or recommendations. It should describe the responsibilities of personnel authorized to sell or recommend nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program. It also should include a description of appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each category of personnel.

The roles of other entities selling on bank premises, including supervision of selling employees — Bank management must plan to monitor compliance by other entities on an ongoing basis. The degree of bank management's involvement should be dictated by the nature and extent of nondeposit investment product sales, the effectiveness of customer protection systems, and customer responses. (*See* "Third Party Vendors," later in this section for more details on programs operated by third parties.)

The types of products sold — Policies and procedures should include the criteria the bank will use to select and review each type of product sold or recommended.

For each type of product sold by bank employees, the bank should identify specific laws, regulations, regulatory conditions, and any other limitation or requirements, including qualitative considerations, that will expressly govern the selection and marketing of products the bank will offer. (*See* "Product Selection," later in this section for further discussion of these issues.)

Examiners should review:

- The process the bank uses to select the products it will offer,
- What the bank did to ensure the products meet its customers' needs and expectations, and
- How well the bank is performing an ongoing analysis of the appropriateness of the products offered for sale.

Examiners will also assess the independence and thoroughness of the analysis and the degree to which the bank relies on ratings services. Examiners should be critical of bank managers who simply choose products that generate the largest sales fees or accept what a third party has to offer without performing an independent analysis of the suitability of the products to the bank's strategy and customer mix.

Examiners should not give the impression that the agency expects bank managers to be "stock pickers" or that it intends to expand or limit the types of products banks offer. Instead, examiners should determine that bankers are selecting products that generally meet their customers' needs.

(*See* "Third Party Vendors," later in this section, for more details on the bank's oversight roles when it relies on its third party vendor to select products.)

Policies governing the permissible uses of bank customer information — Examiners should determine that bank customer information policies address the permissible uses of such information for any purpose

associated with bank-related retail investment sales activity. In particular, if the bank intends to use customer lists to telephone depositors whose certificates of deposit are due to mature to inform them about alternative investment products, the policies should outline steps the bank will take to avoid confusing customers as to the risks associated with nondeposit investment products, including their uninsured nature.

Banks may also supply customer information lists to a third party vendor. Supplying such information should only occur, however, after bank management has evaluated steps the third party is taking to avoid confusing customers and after determining such steps are consistent with bank policy.

Bank management also may wish to consider obtaining a legal opinion concerning the bank's authority to share customer information with third parties.

Communications with customers — Examiners should determine whether the bank's policies consider the need for periodic and ongoing communications with customers to help them understand their investments and to remind customers periodically that the products they have purchased are not insured deposits. Policies should outline customer communications for the bank during periods of market stress and assign responsibilities for such communications.

Setting and Circumstances of Nondeposit Investment Product Sales

Banks should market nondeposit products in a manner that does not mislead or confuse customers as to the nature of the products or their risks. The setting and circumstances surrounding sales of investment products is fundamental to ensuring that customers can readily distinguish between nondeposit investment products and insured deposits. Examiners will determine that bank management has established controls to distinguish retail deposit-taking activities from the promotion, sale, and subsequent customer relationships related to retail nondeposit investment sales.

To minimize customer confusion, sales of, or recommendations for, nondeposit investment products on the bank's premises should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution.

In the limited situation in which physical considerations prevent nondeposit investment product operations from being conducted in a distinct area of the bank, a bank has a heightened responsibility to ensure that measures are in place to minimize customer confusion. To minimize customer confusion, the bank should make an officer responsible for each of the locations at which the investment product sales will take place.

The bank also should employ signs and, where possible, separate desks and personnel for deposit-taking and investment product sales. Investment product salespeople should clearly identify themselves by the use of appropriate methods such as name tags or separate business cards. In banks where the investment program is likely to be less elaborate, the examiner should determine, at a minimum, that the bank utilizes the written and oral disclosures described below.

In no case should any employee, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may only refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

Retail Nondeposit Investment Sales

Introduction

Product names — Banks may not offer nondeposit investment products with a product name identical to the bank's name. Names that imply that mutual funds are U.S. government guaranteed also are prohibited.

Banks also should recognize that the potential for customer confusion may be increased if the bank offers nondeposit product names that are similar to the bank's name. If the bank offers such nondeposit products with names similar to the bank's, it should design sales training programs to minimize the risk of confusing customers.

In addition, Securities and Exchange Commission (SEC) staff have issued an opinion that common names between a bank and a mutual fund sold or marketed by or through that bank are presumed to be misleading and a violation of the Investment Company Act of 1940. SEC staff contends, however, that a common name fund can rebut the presumption that a fund's name is misleading by ensuring that the cover page of the prospectus prominently discloses that the fund's shares are not deposits or obligations of the bank and are not federally insured.

When examining investment sales programs in a bank that is selling funds with names similar to the bank's, examiners will evaluate the steps that bank management has taken to avoid confusing customers. The greater the similarity between bank and fund names, the more closely examiners will scrutinize all aspects of a bank's sales program.

Examiners should criticize sales programs in which fund names are so similar to the bank's that even mitigating circumstances are unlikely to eliminate customer confusion. For example, it may be acceptable for "First National Bank" to offer a nondeposit investment product named "First Fund" as long as the bank has implemented sufficient disclosures, training, and other measures to mitigate customer confusion. Other names, however, such as "First Bank Fund" or "First National Fund" are so similar to a bank's name that they are inappropriate because they are inherently confusing.

Examiners and bank management should also be aware that the potential for customer confusion can depend on the context in which the sales are taking place. For example, it may be inappropriate for the First National Bank to offer a mutual fund product named "FNB Money Market Fund" if First National Bank were also offering an insured deposit product named "FNB Money Market Account."

Overall setting and circumstances — When reviewing nondeposit investment product sales operations, examiners should not place undue weight on a single aspect of the setting and circumstances of the sale. Each bank's sales program is different, and one set of rules may not cover all circumstances or provide all customers with the necessary level of protection. Before judging a particular bank's operations, examiners should consider how the various elements of the program interact and whether the elements combined mislead or avoid misleading customers.

The following example illustrates how the combination of certain elements can potentially mislead customers:

> An employee of the First National Bank sits at a desk in the lobby. This employee sells money market mutual funds and renews CDs. The employee tells customers about two products the bank is offering: the FNB Money Market Fund, an uninsured retail nondeposit investment product, and the FNB Money Market Account, an insured deposit. This employee may have an incentive to market the uninsured product because the employee gets a commission for selling a mutual fund but receives nothing for selling or renewing a deposit.

This situation could confuse customers. To mitigate customer confusion, the bank should ensure that the employee has extensive knowledge of the products being sold and that the employee is thoroughly aware

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of customer protection issues. When selling noninsured products, the employee should also require customers to sign a new account form acknowledging that the product is not insured.

If space and personnel limitations appear to increase the potential for customer confusion, examiners should encourage bank management to require additional training and disclosures, to develop signs and product names that clearly distinguish among the products being sold, and to assure that compensation for selling uninsured and insured products is equalized. Examiners should expect banks with nondeposit investment sales programs already in operation when this section is issued to initiate actions immediately to conform all aspects of the setting and circumstances of the bank's program to these requirements. In particular, banks should take immediate steps to correct any elements that could confuse customers.

Disclosures and Advertising

Disclosures

Complete and accurate disclosure must be provided to avoid customer confusion as to whether a bank-related product is an investment product or an insured bank deposit. Examiners should determine that banks selling, advertising, or otherwise marketing nondeposit investment products to retail customers provide the following product disclosures conspicuously: **The products offered (1) are not FDIC insured, (2) are not deposits or other obligations or guarantees of the bank, and (3) involve investment risks, including possible loss of principal amount invested.**

The minimum disclosures should be provided to the customer:

- Orally during any sales presentation.
- Orally when investment advice concerning nondeposit investment products is provided.
- Orally and in writing prior to or at the time an investment account is opened to purchase these products.
- In advertisements and other promotional materials, as described below.

Examiners will determine whether these disclosures are featured conspicuously in all written or oral sales presentations, advertising and promotional materials, prospectuses, confirmations, and periodic statements that include the name or the logo of the bank or an affiliate.

Advertisements and brochures also should feature these disclosures at least as large as the text describing the bank's nondeposit investment products. The OCC believes that these disclosures are conspicuous when they appear on the cover of a brochure or on the first part of relevant written text. A bank's disclosures could also be considered conspicuous if it prints the required disclosures in a box or by displaying them in bold type or with bullet points.

The bank should obtain a signed statement acknowledging such disclosures from customers at the time a retail nondeposit investment account is opened. For accounts established before issuance of this section, the bank should consider obtaining such a signed statement prior to the next sale. If the bank solicits customers by telephone or mail, it should be assured that customers agreeing to purchase nondeposit investment products receive the disclosure acknowledgement form when they open a new account. A bank should also request all customers who previously opened investment accounts by mail without receiving these written disclosures to sign and return a disclosure acknowledgement to the bank.

Confirmations and account statements for nondeposit investment products should contain at least the minimum disclosures if the confirmation or account statement contains the name or logo of the bank or its affiliate. If a customer's periodic deposit account statement includes account information about nondeposit investment products, the bank should clearly separate that information from information about the deposit account. The material on the cus-

tomer's periodic deposit account relating to nondeposit investment products also should begin with the disclosures described above as well as the identity of the entity conducting the nondeposit transaction.

Where applicable, examiners should determine that the bank has made additional disclosures described in the Interagency Statement regarding affiliate relationships and specific fees and penalties.

Some disclosure obligations may arise from the roles a bank or a bank affiliate may play in the distribution, administration, and/or management processes. For example, a bank should disclose remuneration received for performing investment advisory services and administrative services such as shareholder accounting. This disclosure obligation may be met through fee disclosures in a prospectus. If the prospectus does not include such fee disclosures, the bank must make the disclosures by some other means. State law requirements may also govern fee disclosures.

Additional disclosure responsibilities may occur because of the manner in which nondeposit investment products are marketed. Examiners should determine whether public statements about the selection of the products a bank offers are reasonable. As an example, if management represents to customers that it has performed an independent analysis of the product selected, the examiner should determine that the bank has actually done so. Examiners will also evaluate management's disclosure to prospective customers of ratings applicable to a particular product, including the source of the rating. If ratings are used to promote certain products, examiners should expect bank management to review whether the bank will disclose ratings changes and, if so, determine how such disclosures will occur.

Examiners should also determine whether a bank-related sales program includes any written or oral representations to customers concerning insurance coverage provided by any other entity apart from FDIC, *e.g.*, the Securities Investor Protection Corporation (SIPC), a state insurance fund, or an insurance company. If these types of representations are made, examiners should determine whether training concerning differences in insurance coverage is provided to appropriate personnel. Appropriate personnel includes anyone who is likely to respond to customer inquiries or individuals designated to sell such products. Examiners should also determine if written or oral explanations of the differences in coverage are provided to all customers.

Advertising

Examiners should assess the procedures the bank uses to ensure that bank-related sales advertisements are accurate, do not mislead customers about the nature of the product, and include required disclosures. For example, claims about "no fees" or "no charges" are not accurate if the selling bank collects fees for investment advisory services or collects fees for shareholder accounting on the product or service being advertised. In this case a bank could claim that there are no "sales" charges and inform readers that a description of other charges is contained in the prospectus.

Examiners should determine that the bank does not imply in advertising or in written and oral presentations that the bank stands behind an investment product.

The bank's marketing department should not be solely responsible for bank-related investment sales advertisements. The issuer, or, if a mutual fund, the distributer, may prepare advertisements of specific investment products that conform to standards developed by self-regulatory organizations such as NASD. Senior bank management should appoint an officer responsible for ensuring that bank investment advertisements as well as advertisements prepared by another party that make reference to the bank, or any advertisement used in bank-related sales, are accurate, not misleading, and include all required

disclosures.

Suitability

Consistent with the Rules of Fair Practice, the OCC expects banks to determine whether a product being recommended is an appropriate investment for the customer. Banks should ensure that any salespeople involved in bank-related sales obtain sufficient information from customers to enable the salesperson to make a judgment about the suitability of recommendations for particular customers. At a minimum, suitability inquiries should be made consistent with the Rules of Fair Practice concerning the customer's financial and tax status, investment objectives, and other factors that may be relevant, prior to making recommendations to the customer. This information should be documented and updated periodically.

A well-documented suitability inquiry can protect a bank from dissatisfied customers who threaten litigation. Such litigation could introduce risk to the bank's capital. Accordingly, the OCC may view banks operating a retail securities business without appropriate suitability procedures to be engaging in an unsafe and unsound practice.

Many banks use software programs that document investor profiles to assist in making suitability judgments. Each profile is based on a customer's responses to inquiries as to his or her financial and relevant personal history. The software program subsequently matches the customer's investment needs and objectives to the bank's available products. This type of software is a tool, not a substitute for professional judgement; it should not weight bank proprietary products too heavily or bank deposits too lightly.

One example of a critical suitability determination involves sales to elderly bank customers. Many of these customers rely upon investments or savings for retirement income and may consequently demand high yields. They may not, however, have the ability to absorb or recover losses. A nondeposit investment salesperson should also be aware that it is especially important to make a careful suitability recommendation when dealing with a surviving spouse who is not experienced in investment matters.

Examiners should investigate potential suitability problems in mutual fund sales when reviewing "breakpoints" and "letters of intent." Breakpoints are discounts that are available to investors who purchase a large amount of mutual fund shares in a lump sum or as part of a cumulative investment program (*e.g.* under a "letter of intent"). The potential for abuse usually occurs when the sale of several different mutual fund shares takes place in quantities just below the level at which the purchaser would qualify for reduced sales charges on any one of the funds.

Examiners should determine whether a bank officer has been assigned responsibility for implementing and/or monitoring the suitability system. The examination approach should focus on the system the bank has in place to make suitability inquiries, suitability judgements, and periodic account reviews. Examiners generally should review sales patterns rather than individual sales for suitability issues. To determine the types of sales to test for suitability, examiners should investigate marketing programs that target a class of customers, customer complaints, sales to first-time and risk-averse investors, sales made by high- or low-volume salespersons, volatile and new products, and the existence of mutual fund redemptions after relatively short holding periods.

Qualifications and Training

Banks should implement detailed training programs to ensure that sales personnel have thorough product knowledge (as opposed to simple sales training for a product) and understand customer protection requirements. Examiners should assess the process the bank uses to ensure that sales personnel are properly qualified

and adequately trained to sell all bank-related nondeposit investment products. If bank personnel sell or recommend securities, the training should be substantively equivalent to that required for personnel qualified to sell securities as registered representatives. Securities industry training is available in most metropolitan areas.

Examiners also should determine that the bank's audit and compliance personnel and persons with supervisory responsibilities are properly trained and knowledgeable.

A bank's hiring practices and training plan should be designed around the complexity and risks of the particular investment products being offered. While it may be appropriate to have a banking generalist with no securities industry background sell money market mutual funds, it could be inappropriate to allow this individual to sell fixed-rate annuities without extensive training.

If individuals with securities industry experience are hired to sell investment products for banks, they should have an understanding of securities industry customer protection and control systems and have an adequate knowledge of the products being offered. Since they may not be familiar with general banking regulations and may not understand the needs of bank customers, banks should also ensure that these individuals are instructed as to the specialized obligations of selling investment products in a retail banking environment. Examiners should expect management to check with securities regulators to determine if potential bank sales employees with previous securities industry experience have a disciplinary history.

Banks engaging in lower volume mutual fund and annuity sales frequently train existing bank employees to sell investment products. Examiners should determine that bank management is satisfied that these individuals have acquired "product knowledge," and thoroughly understand the need to safeguard the customers' interests. More specialized "product knowledge" training is generally provided by the marketing division of a mutual fund sponsor or another third party vendor. Bank staff should also receive customer protection and compliance training.

Examiners should determine whether a bank officer has been assigned responsibility for ensuring that adequate training is provided to bank staff, and for reviewing the hiring and training practices of a third party vendor.

Compensation

Incentive compensation systems, which are standard in the securities and insurance businesses, are becoming increasingly common in commercial banking. Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.

An improperly designed compensation system can provide a bank employee with the incentive to place his or her own compensation interests above the interests of bank customers. Examiners should assess the steps management has taken to ensure that compensation programs do not operate as an incentive for salespeople to make unsuitable recommendations or sales to customers.

One way to avoid having the compensation system drive the recommendation toward mutual funds and away from certificate of deposit renewals would be to separate the nondeposit investment product sales and CD renewal functions. Alternatively, if employees are permitted to offer both deposits and nondeposit investment products, a bank could reduce the temptation by compensating the employee for renewing maturing deposits as well as for selling nondeposit investment products. Examiners should discuss with bank management where appropriate the methods used to avoid possible conflicts of interest poten-

tially arising from the bank's compensation plan.

To investigate whether incentive compensation schemes could induce salespersons to recommend products with higher commissions over a more suitable option, examiners should look to customer complaints and to sales patterns rather than to individual sales. For example, an examiner can look for instances in which sales for a particular product increased after changes to an incentive compensation system.

Examiners also should expect a bank to increase its supervision of sales programs as it increases its incentive compensation. Examiners should be critical of supervision that does not take into account the possibility that recommendations for purchases of nondeposit investment products could be influenced by the incentive compensation scheme.

If the overall setting and circumstances of a bank's investment sales program appears to be only marginally satisfactory, examiners should regard higher incentive compensation on certain investment products and lower compensation on deposits and other investment products as having the potential for causing serious problems. In this case the compensation system itself should justify an increase in the level of bank management supervision. If supervision is not adequate, the examiner should criticize the compensation system and other objectionable factors in the setting and circumstance of the sale.

Bank supervisory employees who review and approve individual sales, accept new accounts, and review established customer accounts should not receive incentive compensation based on the profitability of individual trades or accounts that are subject to their review. Similarly, department auditors or compliance personnel should not participate in incentive compensation programs that are based directly on the success of sales efforts nor should they report to a manager who receives this type of incentive compensation. In addition, bank management should not rely on third party audit and control systems if that vendor's control personnel receive transaction-based incentive compensation.

Bank employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referred for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

Fiduciary Accounts

Pursuant to 12 CFR 9.11(d), examiners will review the investments held by national banks as fiduciary to determine whether such investments are in accordance with law, 12 CFR 9, and sound fiduciary principles. In so doing, they will ensure that the bank has complied with all applicable state and federal restrictions on investment transactions involving the bank's fiduciary accounts.

Under 12 CFR 9.12, national bank fiduciaries may not invest funds held as fiduciary in the stock of organizations with which there exists such a connection as may affect the exercise of the best judgment of the bank in acquiring the stock, unless there exists specific authority for such an investment in the governing instrument, local law, a court order or through consents from all beneficiaries. As to accounts subject to the Employee Retirement Income Security Act of 1974, such investments must be within the authority of that Act. These principles govern purchases of a bank's proprietary products, such as bank-advised mutual funds and private label mutual funds for fiduciary accounts.

In addition, pursuant to 12 CFR 9.11(d), examiners will determine that fiduciary purchases and retention of bank proprietary products for fiduciary accounts are in accord with sound fiduciary principles. This requires that even if specific authority exists for fiduciary accounts to purchase or retain bank-advised or bank private label mutual funds, the assets must be appropri-

ate for each account. The investment must be consistent with the purpose for which each account was created, and suitable for the beneficial interest holders of each account. This requirement exists as to purchases for individual accounts, and for conversions of collective investment funds to bank-advised mutual funds.

Twelve CFR 9.7 requires banks to conduct initial and annual reviews of each fiduciary account as well as a separate review of all securities by issuer to ensure compliance with these requirements. These reviews include:

- A documented review of each account to determine that the assets of that account, including any proprietary products, meet the investment objectives of the account. In structuring the account portfolio, the fiduciary must consider the provisions of the document establishing the account. The review must also take into account the needs of the beneficial interest holders. This review should address the issues set forth in the *Comptroller's Handbook for Fiduciary Activities*, "Portfolio Management."
- A documented annual review of all assets by issuer, including proprietary products. This review should consider the quality of fund management, fee structure, risk diversification and anticipated rates of return. It should also address the considerations set forth in the *Comptroller's Handbook for Fiduciary Activities*, "Investments."

Compliance Program

Banks must maintain compliance programs capable of verifying compliance with the guidelines specified in the Interagency Statement and with any other applicable requirements. Banks should perform nondeposit investment compliance programs independently of investment product sales and management. At a minimum, the compliance function should include a system to monitor customer complaints and to review customer accounts periodically to detect and prevent abusive practices.

Examiners reviewing the compliance operations of a bank offering a variety of retail investment products should ensure that the bank has comprehensive self-regulatory policies and that it is conducting an ongoing comparison of the bank's investment sales practices with its stated investment policy. In banks with a less elaborate investment sales program, where an internal auditing group may perform all of the bank's compliance functions, the examiner should ensure that these auditors are periodically comparing sales practices with policy.

Individuals performing the audit or compliance of the bank's investment program should be qualified and should have the necessary experience to perform the assigned tasks. Compliance personnel should also engage in ongoing training to keep abreast of emerging developments in banking and securities laws and regulations.

Banks can establish independence of audit or compliance personnel if such personnel determine the scope, frequency, and depth of their own reviews; report their findings directly to the board of directors or an appropriate committee of the board; have their performance evaluated by persons independent of the investment product sales function; and receive compensation that is not connected to the success of investment product sales.

Bank compliance programs should be modeled after those in the securities business where it is customary for compliance personnel to conduct regular and frequent customer account reviews in order to detect and prevent abuses. The extent and frequency of customer account supervision should be dictated by the aggressiveness of the sales program and the riskiness of products being offered.

Examiners should expect the bank to assign individuals independent of the sales

force to review periodically customer responses to suitability inquiries and to compare these responses to the type and volume of account activity to determine whether the activity in an account is appropriate. If account activity is unusual relative to the customer's stated objectives and risk tolerance, or if account activity is brisk relative to the size of a customer's investment or past practices, management should make follow-up inquiries to determine if the activity serves the best interests of the customer.

If examinations or routine oversight by bank management indicates that suitability problems may exist, bank management is expected to conduct its own review of all affected accounts and to institute corrective actions. If it is determined that customers may have been disadvantaged, corrective actions should be designed on a case-by-case basis and may include full explanations to customers and, where appropriate, offers to rescind trades.

Customer complaints are an indication of potential problems that warrant a prompt account review. Examiners should expect the bank to assign a bank officer who is independent of the sales force the responsibility for approving the resolution of complaints or reviewing the resolution of complaints by a third party vendor. The examiner should evaluate the system for assuring that all complaints (written and oral) receive management's attention by reviewing the bank's audit of the complaint resolution system.

Managers of high-volume investment sales programs also often use automated exception reporting systems to flag potential problems before customers complain. Such systems monitor product sales and the performance of salespersons. If the bank has such systems in place, and if the reports show significant volumes of mutual fund redemptions after short holding periods, examiners should review the steps management has taken to investigate whether the product is being sold properly. If early redemptions are restricted to one salesperson or one branch, management can reasonably conclude that the problem is localized. However, early redemptions occurring throughout the sales network may indicate that something is wrong with the product itself or with the training provided to salespeople. Similarly, if reports indicate that a salesperson is selling one type of product almost exclusively, management may need to review that individual's performance or training.

Ultimately, the way for bank management to assure itself that the securities salespersons are providing the required disclosures and making suitable recommendations to customers is to "test" the sales program. Effective "tests" can be conducted in several ways. Larger banks sometimes employ "testers" who pose as prospective customers and test the sales presentations for a variety of issues including adherence to customer protection standards. Many other well-managed banks (of all sizes) have instituted follow-up programs to verify that their customers understood their investment transactions. A bank manager, who is independent of the sales force, may telephone customers a few days after an investment account is opened or an unusual transaction has taken place. The manager will determine if the customer understands what he or she has purchased; understands the risks, including the uninsured nature of the product; understands the bank's role in the transaction; and can generally confirm responses to a suitability inquiry previously provided.

A bank officer usually can determine if a customer understands an investment by asking the customer to describe its general features. The customer should be able to describe how the product works and its risks rather than simply recite what he or she hopes to gain from the particular investment. Managers usually also determine if the customer is satisfied with the product and service or has any problems or suggestions for improving service. If a bank institutes a telephone follow-up program, it should maintain a record of con-

versations with customers to resolve problems or disputes that may arise at a later date.

"Negative consent" letters (*e.g.*, notices informing customers that unless they object, the bank assumes the customer understands and does not object to the transactions) may be a useful element in a compliance program but should not be the sole means of verifying that customers understand nondeposit investment product transactions and the bank's role in the process.

Examiners should determine whether a bank officer has been assigned the responsibility for assuring that the bank adequately monitors the nondeposit investment accounts of customers. Examiners should also determine whether the officer has developed or is developing a system to monitor the customer account reviews of outside vendors operating bank-related sales programs.

Oversight of Third Party Vendors

When a bank uses a third party vendor to sell nondeposit investment products, the bank's board of directors must adopt a written policy addressing the scope of the activities of the third party, as well as the procedures the bank intends to use for monitoring the third party's compliance with the Interagency Statement.

To select the third party vendor and monitor the ongoing acceptability of the vendor, bank management usually reviews the vendor's experience in the business and the vendor's financial statement. Bank management also usually contacts other banks with which the vendor has done business for references. Examiners should also expect that bank management checked with the vendor's regulator before it entered into an agreement with the vendor and that management has continued to review reports furnished to the vendor by its regulator(s).

Bank management should enter into a written agreement with a third party vendor that has been approved by the bank's board of directors before the vendor is permitted to offer nondeposit investment products to the bank's customers. The agreement should outline the duties and responsibilities of each party and should include a description of all of the activities the third party is permitted to engage in on the bank's premises. The agreement also should set forth terms for the use of the bank's space, personnel, and equipment as well as compensation arrangements for personnel of the bank and the third party. The agreement also should:

- Specify that the third party will comply with all applicable laws and regulations and will act consistently with the provisions of this temporary insert, especially the provisions relating to customer disclosures,
- Authorize the bank to monitor the third party by periodically reviewing and verifying that the third party and its sales representatives are complying with its agreement with the bank, with all applicable laws and regulations, and with the provisions of this temporary insert,
- Specify the type, scope, and frequency of reports the third party is to furnish to bank management to permit bank management to fulfill its oversight responsibilities,
- Authorize the institution and the OCC to have access to appropriate records of the third party,
- Require the third party to agree to indemnify the bank for any liability that resulted from third party investment product sales program actions,
- Set forth the training which the bank expects its employees and third party personnel to possess, and
- Provide for written employment contracts between the bank and the third party vendor's employees.

Examiners will review the agreement to determine that it specifies that the third party vendor will comply with all applicable requirements contained in the Interagency Statement. Examiners also will review the

agreement to determine if it includes provisions regarding bank oversight and examiner access to appropriate records. It is expected that compliance with the agreement will be periodically monitored by the institution's senior management.

Before entering into an agreement with a third party vendor, bank management also should be satisfied that the vendor uses a product selection process similar to the one outlined below. Banks relying on a third party vendor to select products also should understand and agree with the vendor's method of analysis and document its concurrence with that method. Examiners should determine whether management has understood and concurred. Bank management should periodically investigate the vendor's product selection process to ensure that it continues to be appropriate to the bank's customer mix. Examiners also should determine whether bank management understands and agrees with contingency plans developed by the third party vendor and the product issuer to respond to customer orders during unusual surges in redemptions.

To fulfill its oversight responsibilities, it is expected that bank management will receive various reports from the third party vendor and have access to the vendor's appropriate records. The reports received will vary with the scope of the sales program and should be tailored to the needs of the institution. The reports should always include a list of all customer complaints and their resolution. Other reports that may facilitate bank management's oversight role, could include:

- A periodic listing of all new account openings and descriptions of the initial trades;
- A list of significant or unusual (for the customer) individual sales during a reporting period;
- Sales reports by product, salesperson, and location during a reporting period; and
- Reports of internal compliance reviews of customer accounts originated at the bank and reports furnished to the third party vendor by its regulator(s) on at least an annual basis.

Bank management must monitor compliance by third party vendors on an ongoing basis. Senior bank managers will be expected to ensure that specific individuals employed by the bank and by the third party vendor are responsible for each activity outlined in the bank's investment sales policy. The degree of bank management's involvement should be dictated by the types of products being offered, the volume of sales, the nature of customers' complaints, and the effectiveness of the third party vendor's customer protection systems.

Senior bank management also should appoint an officer responsible for ensuring that bank investment advertisements as well as advertisements prepared by another party that refer to the bank, or any advertisement used in bank-related sales, are accurate, not misleading, and include all required disclosures. In addition, any advertising or promotional material — prepared by or on behalf of a third party vendor — should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller.

Examiner access to the records of third party vendors should be governed by preliminary examination findings. When such findings make it clear that bank management has discharged its oversight responsibility by reviewing and responding appropriately to third party reports, only a few customer complaints have been filed against the vendor, and the vendor's reports are timely, sufficiently detailed, and prepared by someone independent of the vendor's sales force, examiner access to third party records should generally be limited to the reports furnished to management by the vendor.

Product Selection

This section describes in general terms the methods that well-managed banks use to

select specific nondeposit investment products and to determine that such products continue to be acceptable to the bank's customer mix. This information is provided to help examiners understand and review the process used by well-managed banks to make this determination.

Bank management should determine the specific laws, regulations, regulatory conditions or other limitations or requirements, including qualitative considerations, that will govern the sale of products to be offered. Although not required, most well-run bank investment sales programs limit the number of products offered so that customers and salespersons will not be presented with an overwhelming number of choices. Limitations based on product quality may also make it easier for sales managers to shield certain classes of customers from inappropriate products.

As a general practice, bank investment programs offer at least one type of money market mutual fund for customers who are interested in liquidity. In addition, most banks offer a U.S. government bond fund for customers who stress safety and steady income, an equity fund for customers interested in capital growth, and a tax-exempt bond fund for customers who wish to avoid taxes on investment earnings.

When deciding which funds to offer, managers should review the fund's performance over an extended period of time. Most bank managers prefer to avoid mutual funds with volatile records. Management's selection of a family of funds should not be based on the performance of one particular fund; each fund selection should stand on its own merits.

Management's selection of investment products usually begins with an evaluation of the stability of asset values over time and an assessment of yields to investors. Management also compares the performance of other funds with similar objectives over the same period(s). Specialized ratings services (such as Morningstar or Lipper) or rankings by analytical services are usually regarded as necessary but secondary considerations.

Management also considers the fund's track record in terms of both risk and reward. Management analyzes the fund's net asset value versus total return, its management or operating expenses, the turnover within the fund's portfolio, and capital gains and other sources of income. Other key considerations include the composition of the portfolio and concentrations in types of holdings, sector weights, and, in the case of equity funds, the percentage of ownership represented by individual issues.

Management also evaluates important nonstatistical factors such as the continuity, tenure, and demonstrated talent of the fund's management. They also may consider factors such as the quality of a mutual fund's operational and marketing support.

The bank itself, and not another entity's marketing department, should select the funds to be offered. Independent committees and qualified analysts should make the final selections, not a sales manager whose view of the commission structure may affect this judgment.

If the bank uses outside consultants to help select a mutual fund, bank management should determine whether the consultant receives compensation from mutual funds or mutual fund wholesalers. If the analysis is performed by another party, such as a clearing broker or third party vendor, bank management should understand and agree with the method of analysis and should document the bank's concurrence.

Regardless of who selects the mutual fund products, bank management will be expected to consider the issuer's contingency plans for handling unusual surges in redemptions at the time such products are being considered. Such contingency plans normally include emergency staffing, communications, and operational programs that are based on various market scenarios.

Retail Nondeposit Investment Sales

Bank management should compare these contingency plans to the expected needs of bank customers during periods of stress.

Finally, once the initial selection process is complete, bank management should conduct ongoing reviews to assure that the products remain acceptable in light of the bank's objectives and customer's needs.

Selection of annuity products is conducted in the same manner. A variable-rate annuity, a hybrid form of investment that contains elements of mutual funds and insurance, could be characterized as a mutual fund operated by an insurance company. During product selection, bank management should consider the performance and composition of the portfolio that is dedicated to the annuity holders.

Selection analysis for fixed-rate annuities differs from variable-rate annuities. Since fixed-rate annuities are obligations of insurance companies, the risks associated with them relate to the issuer's ability to honor the terms of the annuity contract. Accordingly, the safety of an annuity depends upon the financial standing of the firm that issues it and the selection analysis involves an assessment of the quality and diversification of the company's assets, its holdings of junk bonds, mortgage-backed securities, and problem real estate loans, as well as the continuity of management.

Because it is difficult to independently analyze insurance companies, ratings provided by rating agencies such as A.M. Best, Standard & Poor's, Duff & Phelps, Moody's and Weiss Research play a part in annuity analysis. If bank management relies significantly on such ratings rather than on its own analysis, however, examiners should expect that the issuer selected by the bank has received top ratings from most of the ratings services.

When analyzing annuities, management also should recognize that an issuing insurance company can, in certain circumstances, sell or simply transfer the annuity contract to another insurance company, thereby extinguishing its obligation to the purchaser of the annuity. Annuity owners are generally, but not always, asked to consent to this transfer. A bank selling annuities should consider the possibility of such a transfer in its product selection analysis. At a minimum, the bank should disclose this possibility to prospective customers.

Interagency Statement on Retail Sales on Nondeposit Investment Products

The full text of the interagency statement begins on the next page.

Retail Nondeposit Investment Sales

Interagency Statement on Retail Sales on Nondeposit Investment Products

February 15, 1994

Introduction

Recently many insured depository institutions have expanded their activities in recommending or selling to retail customers nondeposit investment products, such as mutual funds and annuities. Many depository institutions are providing these services at the retail level, directly or through various types of arrangements with third parties.

Sales activities for nondeposit investment products should ensure that customers for these products are clearly and fully informed of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to retail customers, depository institutions should ensure that customers are fully informed that the products:

- Are not insured by the FDIC;
- Are not deposits or other obligations of the institution and are not guaranteed by the institution; and,
- Are subject to investment risks, including possible loss of principal invested.

Moreover, sales activities involving these investment products should be designed to minimize the possibility of customer confusion and to safeguard the institution from liability under the applicable anti-fraud provisions of the federal securities laws, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of securities.

The four federal banking agencies — the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision — are issuing this Statement to provide uniform guidance to depository institutions engaging in these activities.

(**Note:** Each of the four banking agencies has in the past issued guidelines addressing various aspects of the retail sale of nondeposit investment products. OCC Banking Circular 274 (July 19, 1993); FDIC Supervisory Statement FIL-71-93 (October 8, 1993); Federal Reserve Letters SR 93-35 (June 17, 1993), and SR 91-14 (June 6, 1991); OTS Thrift Bulletin 23-1 (September 7, 1993). This Statement is intended to consolidate and make uniform the guidance contained in the various existing statements of each of the agencies, all of which are superseded by this Statement. Some of the banking agencies have adopted additional guidelines covering the sale of certain specific types of instruments by depository institutions, *i.e.*, obligations of the institution itself or of an affiliate of the institution. These guidelines remain in effect except where clearly inapplicable.)

Scope

This Statement applies when retail recommendations or sales of nondeposit investment products are made by:

- Employees of the depository institution;
- Employees of a third party, which may or may not be affiliated with the institution (*see* **Note**, below, addressing which institutions are covered), occurring on the premises of the institution (including telephone sales or recommendations by employees or from the institution's premises and sales or recommendations initiated by mail from its premises); and
- Sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

(**Note:** This Statement does not apply to the subsidiaries of insured state nonmember banks, which are subject to separate provisions, contained in 12 CFR 337.4, relating to securities activities. For OTS-regulated institutions that conduct sales of nondeposit investment products through a subsidiary, these guidelines apply to the subsidiary. 12 CFR 545.74 also applies to such sales. Branches and agencies of U.S.

foreign banks should follow these guidelines with respect to their nondeposit investment sales programs.)

These guidelines generally do not apply to the sale of nondeposit investment products to non-retail customers, such as sales to fiduciary accounts administered by an institution. (Note: Restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, are set out in 12 CFR 9.12. Similar restrictions on transactions between funds held by a federal savings association as fiduciary and any person or organization with whom there exists an interest that might affect the best judgment of the association acting in its fiduciary capacity are set out in 12 CFR 550.10. However, as part of its fiduciary responsibility, an institution should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to the institution's fiduciary customers.)

Adoption of Policies and Procedures

Program Management. A depository institution involved in the activities described above for the sale of nondeposit investment products to its retail customers should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the features of the institution's program and addressing, at a minimum, the concerns described in this Statement. The written statement should address the scope of activities of any third party involved, as well as the procedures for monitoring compliance by third parties in accordance with the guidelines below. The scope and level of detail of the statement should appropriately reflect the level of the institution's involvement in the sale or recommendation of nondeposit investment products. The institution's statement should be adopted and reviewed periodically by its board of directors. Depository institutions are encouraged to consult with legal counsel with regard to the implementation of a nondeposit investment product sales program.

The institution's policies and procedures should include the following:

- **Compliance procedures.** The procedures for ensuring compliance with applicable laws and regulations and consistency with the provisions of this Statement.
- **Supervision of personnel involved in sales.** A designation by senior managers of specific individuals to exercise supervisory responsibility for each activity outlined in the institution's policies and procedures.
- **Types of products sold.** The criteria governing the selection and review of each type of product sold or recommended.
- **Permissible use of customer information.** The procedures for the use of information regarding the institution's customers for any purpose in connection with the retail sale of nondeposit investment products.
- **Designation of employees to sell investment products.** A description of the responsibilities of those personnel authorized to sell nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program, and a description of any appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each class of personnel.

Arrangements with Third Parties. If a depository institution directly or indirectly, including through a subsidiary or service corporation, engages in activities as described above under which a third party sells or recommends nondeposit investment products, the institution should, prior to entering into the arrangement, conduct an appropriate review of the third party. The institution should have a written agreement with the third party that is approved

by the institution's board of directors. Compliance with the agreement should be periodically monitored by the institution's senior management. At a minimum, the written agreement should:

- Describe the duties and responsibilities of each party, including a description of permissible activities by the third party on the institution's premises, terms as to the use of the institution's space, personnel, and equipment, and compensation arrangements for personnel of the institution and the third party.
- Specify that the third party will comply with all applicable laws and regulations, and will act consistently with the provisions of this Statement and, in particular, with the provisions relating to customer disclosures.
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its sales representatives are complying with its agreement with the institution.
- Authorize the institution and the appropriate banking agency to have access to such records of the third party as are necessary or appropriate to evaluate such compliance.
- Require the third party to indemnify the institution for potential liability resulting from actions of the third party with regard to the investment product sales program.
- Provide for written employment contracts, satisfactory to the institution, for personnel who are employees of both the institution and the third party.

General Guidelines

1. Disclosures and Advertising
The banking agencies believe that recommending or selling nondeposit investment products to retail customers should occur in a manner that assures that the products are clearly differentiated from insured deposits. Conspicuous and easy to comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured deposits are understood.

Content and Form of Disclosure. Disclosures with respect to the sale or recommendation of these products should, at a minimum, specify that the product is:

- Not insured by the FDIC;
- Not a deposit or other obligation of, or guaranteed by, the depository institution;
- Subject to investment risks, including possible loss of the principal amount invested.

The written disclosures described above should be conspicuous and presented in a clear and concise manner. Depository institutions may provide any additional disclosures that further clarify the risks involved with particular nondeposit investment products.

Timing of Disclosure. The minimum disclosures should be provided to the customer:

- Orally during any sales presentation,
- Orally when investment advice concerning nondeposit investment products is provided,
- Orally and in writing prior to or at the time an investment account is opened to purchase these products, and
- In advertisements and other promotional materials, as described below.

A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures. For investment accounts established prior to the issuance of these guidelines, the institution should consider obtaining such a signed statement at the time of the next transaction.

Confirmations and account statements for such products should contain at least the minimum disclosures if the confirmations or account statements contain the name or the logo of the depository institution or an affiliate. (Note: These disclosures should be made in addition to any other confirma-

tion disclosures that are required by law or regulation, *e.g.*, 12 CFR 12, 208.8(k)(3), and 344.) If a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account, and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction.

Advertisements and Other Promotional Material. Advertisements and other promotional and sales material, written or otherwise, about nondeposit investment products sold to retail customers should conspicuously include at least the minimum disclosures discussed above and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance. The minimum disclosures should also be emphasized in telemarketing contacts. Any third party advertising or promotional material should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller. If brochures, signs, or other written material contain information about both FDIC-insured deposits and nondeposit investment products, these materials should clearly segregate information about nondeposit investment products from the information about deposits.

Additional Disclosures. Where applicable, the depository institution should disclose the existence of an advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution and any material relationship between the institution and an affiliate involved in providing nondeposit investment products. In addition, where applicable, the existence of any fees, penalties, or surrender charges should be disclosed. These additional disclosures should be made prior to or at the time an investment account is opened to purchase these products.

If sales activities include any written or oral representations concerning insurance coverage provided by any entity other than the FDIC, *e.g.*, the Securities Investor Protection Corporation (SIPC), a state insurance fund, or a private insurance company, then clear and accurate written or oral explanations of the coverage must also be provided to customers when the representations concerning insurance coverage are made, in order to minimize possible confusion with FDIC insurance. Such representations should not suggest or imply that any alternative insurance coverage is the same as or similar to FDIC insurance.

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the depository institution. Recommending or selling a nondeposit investment product with a name similar to that of the depository institution should only occur pursuant to a sales program designed to minimize the risk of customer confusion. The institution should take appropriate steps to assure that the issuer of the product has complied with any applicable requirements established by the Securities and Exchange Commission regarding the use of similar names.

2. Setting and Circumstances

Selling or recommending nondeposit investment products on the premises of a depository institution may give the impression that the products are FDIC-insured or are obligations of the depository institution. To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. However, in the limited situation where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place

Retail Nondeposit Investment Sales

to minimize customer confusion.

In no case, however, should tellers and other employees, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

3. Qualifications and Training
The depository institution should ensure that its personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of customer protection requirements. If depository institution personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives. (Note: Savings associations are not exempt from the definitions of "broker" and "dealer" in Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934; therefore, all securities sales personnel in savings associations must be registered representatives.)

Depository institution personnel with supervisory responsibilities should receive training appropriate to that position. Training should also be provided to employees of the depository institution who have direct contact with customers to ensure a basic understanding of the institution's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to customer referrals. Training should be updated periodically and should occur on an ongoing basis.

Depository institutions should investigate the backgrounds of employees hired for their nondeposit investment products sales programs, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience.

4. Suitability and Sales Practices
Depository institution personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if depository institution personnel recommend nondeposit investment products to customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically.

5. Compensation
Depository institution employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referral for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.

Depository institution compliance and audit personnel should not receive incentive compensation directly related to results of the nondeposit investment sales program.

8. Compliance
Depository institutions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations, the institution's internal policies and procedures, and in a manner consistent with this Statement. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third party sales are being conducted in a manner consistent with the governing agreement with the depository institution.

The compliance function should be conducted independently of nondeposit investment product sales and management activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported directly to the institution's board of directors, or to a designated committee of the board. Appropriate procedures for the nondeposit investment product programs should also be incorporated into the institution's audit program.

Supervision by Banking Agencies

The federal banking agencies will continue to review a depository institution's policies and procedures governing recommendations and sales of nondeposit investment products, as well as management's implementation and compliance with such policies and all other applicable requirements. The banking agencies will monitor compliance with the institution's policies and procedures by third parties that participate in the sale of these products. The failure of a depository institution to establish and observe appropriate policies and procedures consistent with this Statement in connection with sales activities involving nondeposit investment products will be subject to criticism and appropriate corrective action.

Questions on the Statement may be submitted to:

FRB — Division of Banking Supervision and Regulation, Securities Regulation Section, (202) 452-2781; Legal Division, (202) 452-2246.

FDIC — Office of Policy, Division of Supervision, (202) 898-6759; Regulation and Legislation Section, Legal Division (202) 898-3796.

OCC — Office of the Chief National Bank Examiner, Capital Markets Group, (202) 874-5070.

OTS — Office of Supervision Policy, (202) 906-5740; Corporate and Securities Division, (202) 906-7289.

Effective date: February 15, 1994

Retail Nondeposit Investment Sales

Examination Objectives

1. To determine if the bank has taken reasonable steps to ensure that retail customers can distinguish between insured deposits and uninsured nondeposit investment products.

2. To determine if the banks' policies, procedures, and practices provide for an adequate self-regulatory system that is designed to ensure customer protections in all aspects of the sales programs.

3. To ensure that bank management operates the bank's nondeposit investment sales program in a safe and sound manner and complies with OCC guidelines, interagency statements, and all applicable laws and regulations.

4. To initiate corrective action when the bank's policies, practices, procedures, or managerial controls are deficient or when the bank has failed to comply with laws, rules, regulations or OCC guidelines.

Retail Nondeposit Investment Sales

Examination Procedures — Section 413.3

All examiners should be familiar with all examination procedures, and should complete any steps they think are necessary. However, there are some reasonable standards for which procedures form the basis of review of certain types of operations:

For a community bank that uses an independent third party vendor to operate its retail sales program, examiners may find it adequate to complete only the Third Party Vendor section of the ICQs and the related examination procedures.

For a bank that operates its own sales program or operates through a joint venture or an affiliated broker/dealer, an examiner will usually find it necessary to complete all sections at the first examination. At subsequent examinations of sales programs with no apparent weaknesses, completion of only the core examination procedures (indicated in **bold** type) may be adequate. Any concern that surfaces when applying the core procedures may be addressed by expanding the examination.

1. **Complete the Internal Control Questionnaire (ICQ). Note explanations for any negative answers and changes since the last examination.**

Scope of the Examination

2. **To determine the scope of the examination:**
   a. **Meet with senior management of the bank or department to discuss the scope and direction of the retail nondeposit investment sales program.**
   b. **Review the business plan and policy and procedure manual to gain perspective on the nature of the bank's program. Note any significant changes since the last examination.**
   c. **Review compliance and/or audit coverage and reports since the last examination. Note:**
      — **Previously identified strengths and weaknesses, and**
      — **Responses to criticisms in previous audit/compliance and examination reports.**

Program Management

3. Determine the extent of management involvement in the operation, and the quality of management of the retail nondeposit investment sales program. Review:
   - Responses to the Program Management section of the ICQ.
   - Resumes of key officials involved in the management of the sales program to determine their experience and tenure with the bank.
   - Written performance objectives and performance appraisals of key management personnel to determine whether objectives and appraisals incorporate compliance issues, particularly compliance with disclosure and customer protection standards.
   - Reports furnished to senior management and the board of directors to determine whether they are sufficiently timely, accurate and meaningful to permit effective oversight.

4. Review senior management's actions in implementing the retail nondeposit investment sales program and in offering any new products. Specifically determine whether bank management:
   - Participated in the development of the bank's investment sales program strategic plan.
   - Conducted a risk and regulatory assessment and adopted a compliance program directed at ensuring compliance with all applicable laws, rules, regulations, regulatory conditions, and the Interagency Statement's guidelines.
   - Provided for internal audit/compliance participation in the development of the program.
   - Adopted a program management statement aimed at ensuring effec-

tive supervision of the individuals engaged in sales activities - whether they are employees of the bank or of another entity involved in bank-related sales of investment products.

5. Determine how the retail nondeposit investment sales program is managed.
   a. Analyze sales program growth and earnings performance and determine why certain products have high levels of performance. Consider how this performance relates to incentive compensation and the suitability of recommendations to customers.
   b. Review the customer mix and market surveys. Look at trends in identifiable classes of customers and be alert for concentrations by types of customers. Also, try to determine whether customers are viewed as one-time buyers or are being cultivated to establish longer term relationships.
   c. Review the products offered and any market surveys and determine the risk inherent in different products. Consider whether management has attempted to match products to investors' needs in general.
   d. Review projections for the sales program and for different products and determine whether they:
      — Are realistic in light of the bank's customer mix;
      — Relate to bank staffing and training plans for the sales, supervision, and compliance functions; and
      — Are consistent with the bank's overall strategic plan.
   e. Determine the effectiveness of the bank's self-regulatory policies and procedures as measured by the number and type of customer complaints and by responses to the ICQ.

Product Selection

6. Assess the adequacy of management processes to select and review products sold. Review:
   - Responses to the Product Selection section of the ICQ.
   - Methods bank management uses to select products to meet customer needs.
   - Management's comparison of the performance of the products they offer to general market products with similar objectives.

7. Discuss your findings from the product selection review with senior management and make a judgement about the appropriateness of management's decision to continue to offer these products.

Use of Customer Information

8. Determine whether policies governing the permissible uses of bank customer information address the steps to be taken to reduce possible confusion among depositors who are being solicited to purchase nondeposit investment products.

Setting and Circumstances of Sales

9. **Determine whether bank management has established effective controls to distinguish retail deposit-taking activities from retail nondeposit investment sales. Consider how the various elements of the setting and circumstances may interact to influence the customers' perception.**

10. **Where the deposit-taking and securities sale functions are performed by the same personnel, determine if the bank uses appropriate written and oral disclosures to guard against customer confusion, and the extent to which bank staff is trained to use, and does use, such disclosures.**

Disclosures and Advertising

11. Review responses to the Disclosures and Advertising section of the ICQ and a representative sample of each type of advertising and promotional material.
    a. Determine whether all of the required disclosures are featured conspicuously in:
       — All written or oral sales presentations,
       — Advertising and promotional materials,
       — Confirmations and account statements that contain the name or the logo of the bank or an affiliate, and
       — Periodic statements that include information on both deposit and nondeposit products.
    b. Determine, where applicable, if the bank has disclosed the existence of:
       — An advisory or other relationship between the bank and any affiliate involved in providing nondeposit investment products, and
       — Any early withdrawal penalties, surrender charge penalties, and deferred sales charges.
    c. Determine whether bank-related sales advertisements are:
       — Accurate, and
       — Not likely to mislead customers about the nature of the product.
    d. Review product brochures and advertising to ensure that they do not imply that the bank stands behind an investment product. Also determine whether public statements concerning the selection of the products a bank offers are reasonable.
    e. Determine whether personnel make any written or oral representations concerning insurance coverage by any entity other than the FDIC, *e.g.*, Securities Investor Protection Corporation (SIPC); a state insurance fund; or an insurance company.

       If representations about non-FDIC insurance coverage are made, determine whether:
       — Each appropriate person who has contact with customers is trained concerning the differences among those coverages, and
       — Written or oral explanations of the differences in coverage are provided to all customers.

Suitability

12. Judge whether systems in place are adequate to ensure that sales personnel make suitable recommendations and whether management is discharging its responsibilities under these systems by reviewing:
    - Responses to the Suitability section of the ICQ,
    - Customer complaints and resolutions,
    - Sales patterns,
    - Compensation differentials that may influence recommendations, and
    - Compliance and/or audit reports.

13. If your findings in 12, above, are negative or uncertain, review a sample of sales to determine if transactions appear unsuitable for a customer, based on responses to the suitability inquiries. The sample should include transactions involving:
    - Customer complaints,
    - Marketing programs that target a class of customers,
    - First-time and risk-averse investors,
    - High or low volume salespersons,
    - More volatile and newer products, and
    - Redemptions of annuities or mutual funds after relatively short holding periods.

14. If, after the review in 13, above, you are still not certain that recommenda-

tions are suitable, direct bank management to conduct an *independent review* of all affected accounts and to report their findings to the EIC.

15. If you determine that customers may have been disadvantaged, discuss appropriate corrective action with senior management. Such action should be designed on a case by case basis and may include:
    - Full explanations to customers and, where appropriate, offers to rescind trade.
    - A recommendation to bring in an independent audit or special counsel to perform further review of customer transactions.
    - Other action agreed upon between bank management and the EIC.

Qualifications and Training

16. Assess the bank's process for ensuring that supervisory, investment sales, audit, and compliance personnel are properly qualified and adequately trained by reviewing hiring and training practices and future plans and determining whether they are:
    - Designed around the complexity and risks of the investment products being offered, and
    - Consistent with the organization's projections for growth and product line expansion.

Compensation

17. Review the compensation plan and assess the steps management has taken to ensure that compensation programs are not structured in a way that result in unsuitable recommendations or sales being made to customers.
    a. Be alert to increases in the sales volume of a particular product, to customer complaints, and to suitability problems that may relate to the incentive compensation system and/or changes in compensation.
    b. Determine whether supervision of sales programs or of individual product offerings increases as incentive compensation increases.
    c. Determine whether referral fees are, in any way, based on a sale being made.
    d. Review written performance objectives and a sample of performance appraisals for salespersons and determine if the system for motivating and rewarding salespersons strikes a reasonable balance between profitability and the need to protect customer interests.

Sales to Fiduciary Accounts

18. Determine whether, on retail nondeposit investment transactions involving the bank's fiduciary accounts, the bank has complied with all applicable state and federal restrictions, including the Employee Retirement Income Security Act of 1974.
    a. If proprietary or private label sales to trust accounts were executed through the bank's nondeposit investment sales program, determine if the transactions were expressly authorized under state law or if authorization were obtained by the bank.
    b. Determine whether management's justification of any transfer of trust account investments to investments acquired through the bank's nondeposit investment sales program has taken into account all relevant circumstances, account by acccout. Relevant circumstances include:
       — The provisions of the trust account,
       — The beneficiaries' needs,
       — The quality of fund management,
       — The fee structure,
       — Risk diversification, and
       — Rates of return.
    c. Determine whether the trust department conducts periodic re-

views of the ongoing prudence of the investment. Such reviews should cover:
- The quality of the holdings,
- The compatibility of investment objectives, and
- The availability of competing investments, including non-proprietary products, which might better meet the fiduciary account's investment objectives.

Compliance Program

19. **Determine how effective the bank's compliance program is by reviewing:**
    - **Responses to the Compliance Program section of the ICQ,**
    - **The independence of compliance personnel,**
    - **Training provided to compliance personnel,**
    - **Automated exception reporting systems, and**
    - **The scope, frequency, and findings of compliance reviews, and responses to findings.**

20. **Determine whether results of periodic reviews are formally communicated to senior managers independent of the sales function, and whether a follow-up system tracks management responses to noted exceptions.**

21. **If prior examination findings, compliance reports, a pattern of customer complaints, or routine oversight by bank management identifies the possibility that suitability problems may exist, determine if bank management has conducted a thorough review of all affected accounts and instituted appropriate corrective actions.**

Third Party Vendors

22. Determine the effectiveness of the bank's oversight program and whether bank management has discharged its responsibilities under the program.
    a. Review responses under the Third Party Vendor section of the ICQ and the text of the bank's oversight program.
    b. Review the scope and frequency of completed and scheduled oversight reviews and reviews of customer complaints and their resolution.
    c. Review bank management's response to recommendations made during past examinations.
    d. Review the third party vendor agreement and determine:
       - Whether it specifies that such entities will comply with all applicable requirements, including those in the Interagency Statement.
       - How bank management assures itself that third party vendors comply with the terms of the agreement.
    e. Review how bank management determined the adequacy of the steps a third party vendor takes to avoid customer confusion about the nature of the product and the bank's role in the sales process.
    f. Determine whether bank management understands and agrees with the way the third party vendor selects products.

23. After making a judgment about the effectiveness of the oversight of third party vendor sales, complete any other examination procedures that appear appropriate.

Summary

24. **Determine if bank management has demonstrated by its actions whether it believes customers' interests are critical to all aspects of its nondeposit investment product sales programs.**

25. **Discuss significant findings with the EIC and bank management and prepare written comments.**

Retail Nondeposit Investment Sales

Internal Control Questionnaire

Section 413.4

Program Management

1. Has the bank's board of directors adopted a program management statement that addresses:
   - The features of the sales program?
   - The associated risks?
   - The roles of bank employees?
   - The roles of third party entities?

2. Do the bank's policies address the following issues:
   - Program objectives?
   - Strategies to be employed to achieve objectives?
   - Supervision of personnel involved in nondeposit investment sales programs?
   - Supervisory responsibilities of third party vendors who are selling on bank premises?
   - Selection of the products the bank will sell?
   - Permissible uses of bank customer information?
   - Communications with customers?
   - The setting and circumstances of nondeposit product sales?
   - Disclosures and advertising?
   - Suitability of recommendations?
   - Employee qualifications and training?
   - Employee compensation systems?
   - A compliance program?

3. Do written supervisory procedures assign a manager the responsibility for:
   - Reviewing and authorizing each sale?
   - Accepting each new account?
   - Reviewing and authorizing all sales- or account-related correspondence with customers?
   - Reviewing and authorizing all advertising and promotional materials prior to use?

4. Does the bank use written job descriptions to assign management responsibilities?

5. Do policies and procedures for personnel who are not directly involved in nondeposit investment product sales detail what the employees may say and not say about investment products?

Product Selection

6. Does the bank select the products to be offered?

7. If so, does the selection process make use of predetermined criteria that consider the customers' needs?

8. Does a qualified committee or an analyst who is independent of the sales function make the product selections?

9. If the bank uses outside consultants to help select products, does bank management determine if the consultant receives compensation from product issuers or wholesalers?

10. If the product selection analysis is performed by another party, such as a clearing broker or third party vendor, does bank management understand and agree with the analysis method?

11. Does the bank conduct continuing reviews of product offerings to assure that they remain acceptable and are such reviews done at least annually?

12. Does bank management consider, as part of the selection process, the product issuer's contingency plans for dealing with unusual surges in redemptions?

13. Are these contingency plans based on various market scenarios?

14. Do the contingency plans include:
    - Emergency staffing?
    - Additional communications capabilities?

- Enhanced operational support?

15. Does the analysis of fixed and variable rate annuities include a determination of the credit quality of the issuing insurance company?

16. Does the analysis of fixed and variable rate annuities include determining whether the issuing insurance company can sell or simply transfer the annuity contract to another insurance company?

Use of Customer Information

17. Do written policies concerning the use of information about bank customers address:
    - The minimum standards or criteria for identifying a customer for solicitation?
    - Acceptable calling times?
    - The number of times a customer may be called?
    - The steps to be taken to avoid confusing depositors about the nature of the products being offered?

Setting and Circumstances of Nondeposit Sales

18. Has a bank officer been assigned responsibility for reviewing all current and planned nondeposit investment sales locations to determine whether appropriate measures are in place to minimize customer confusion?

19. Are nondeposit investment products sold only at locations distinct from where deposits are accepted?

20. Are sales locations distinguished by use of:
    - Separate desks?
    - Distinguishing partitions, railings, or planters?
    - Signs?

21. If personnel both accept deposits and sell nondeposit investment products, do operating procedures address safeguards to prevent possible customer confusion?

22. Are the people who sell nondeposit investment products distinguished from people who accept deposits by such means as:
    - Name tags or badges?
    - Business cards?

23. Do operating procedures prohibit tellers from offering investment advice, making sales recommendations, or discussing the merits of any nondeposit investment product with customers?

24. Does the bank offer nondeposit investment products with product names that are *not*:
    - Identical to the bank's name?
    - Similar to a deposit product? (Example: XYZ Money Market Fund *vs.* XYZ Money Market Account.)

25. Does the bank avoid using the words "insured," "bank," or "national" in product names?

Disclosures and Advertising

26. Has bank management designated an officer to be responsible for ensuring that bank-prepared investment advertisements and advertisements prepared by any other party are accurate and include all required disclosures?

27. Is a signed statement acknowledging disclosures obtained from each customer at the time that a retail nondeposit investment account is opened?

28. For accounts established prior to the issuance of the Interagency Statement, are procedures in place to ensure that such a signed statement is obtained prior to, or at the time of, the next transaction?

29. Is there a tracking system designed to monitor and obtain missing acknowledgments?

30. Are all salespeople provided written disclosure guidelines for oral presentations?

31. Do the guidelines for oral presentations clearly direct the speaker to:
    - State the required disclosures?
    - Clarify the bank's role in the sales process?

32. If ratings are used in promoting certain products, does bank policy indicate whether the bank will disclose ratings changes?

33. If so, does policy indicate how such disclosures will occur?

34. If the bank is selling annuities which can be transferred to another obligor, is this possibility disclosed to prospective customers?

Suitability

35. Has a bank officer been assigned responsibility for implementing and monitoring the suitability system?

36. Are systems in place to ensure that any salespeople involved in bank-related sales obtain sufficient information from customers to enable them to make a judgment about the suitability of recommendations for particular customers?

37. Do suitability inquiries include information concerning the customer's:
    - Financial and tax status?
    - Investment objectives?
    - Other information such as date of birth, employment, net worth (net of residential real estate), income, current investments, or risk tolerance?

38. Are customer responses to suitability inquiries documented on a standard form or any other method that permits ready review?

39. Is there a tracking system designed to monitor and obtain missing suitability information?

40. Are new accounts reviewed and formally accepted by a manager before the first transfer is finalized?

41. Does the new account acceptance process include a review of the suitability inquiry and customer responses?

42. Is each sale approved in writing by a designated manager?

43. Are breakpoints considered in both the initial recommendation and in the review of the suitability of those recommendations?

44. Is suitability information for active accounts updated periodically?

45. If the bank uses software programs to assist salespersons in making suitability judgments, does the program:
    - Weight bank proprietary products and bank deposits similarly to other products?
    - Consider breakpoints?

46. If a software program is *not* used, has management identified which products meet certain investment objectives, or has management generally categorized products as suitable for either unsophisticated, sophisticated, or risk-averse customers?

47. Does the bank use suitability guidelines that would limit certain transactions with first time or risk-averse investors, or would require a higher level of approval?

48. Is a bank officer who is independent of the sales force assigned responsibility for reviewing complaints and

their resolution?

Qualifications and Training

49. Does the bank's staffing plan consider its nondeposit investment sales program?

50. Does the bank seek to employ dedicated investment specialists and not platform generalists as sales representatives?

51. Does management have written qualification requirements for outside hires of salespeople and sales program managers?

52. Is a system in place to document background inquiries made about new bank sales employees who have previous securities industry experience to check for a possible disciplinary history?

53. Has a bank officer been assigned responsibility for ensuring that adequate training is provided to bank staff?

54. Does the bank have a formal training program for individuals who:
    - Make customer referrals for nondeposit products?
    - Are engaged in retail sales of nondeposit investment products?
    - Are responsible for supervising people who make referrals and/or who engage in selling?

55. Is this training offered as part of:
    - Initial training?
    - Continuing training?

56. Is there a training manual showing the objectives of each initial and subsequent training session?

57. Have lesson plans been developed for in-house programs?

58. Are tellers trained:
    - To not accept orders or sell nondeposit investment products?
    - To avoid offering investment advice?
    - To not make recommendations?
    - To not discuss the merits of any securities with customers?

59. Does the bank provide training that addresses suitability issues?

60. Does suitability training specifically address customer protection issues associated with the most vulnerable classes of investors who may actually prefer the "no investment risk" aspect of insured bank deposits?

61. Is product training provided to:
    - Compliance staff?
    - Audit staff?

62. Does the bank have a formal plan to meet future retail nondeposit investment product sales training needs?

Compensation

63. Are compensation systems set up to avoid paying the same people incentive compensation for the sale of nondeposit investment products when no incentives are paid for renewing certificates of deposit?

64. Do supervisory policies control incentive compensation increases associated with sales contests or the introduction of new products?

65. Are referral programs designed so that employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referred, without regard for whether the sale is made?

66. Do policies prohibit tellers from participating in contests or other promotional programs in which prizes are based on successful sales to customers referred?

67. Do policies and procedures preclude incentive compensation based on the profitability of individual trades by, or accounts subject to the review of, bank employees who:
    - Review and approve individual sales?
    - Accept new accounts?
    - Review established customer accounts?

68. Do policies and procedures preclude payment of incentive compensation to department auditors or compliance personnel?

69. Does the management structure preclude control, audit or compliance personnel from reporting to managers whose compensation is based on profits from nondeposit investment products sales?

70. Does the compensation program reduce remuneration to sales program managers whose accounts show:
    - Missing documents?
    - Unreported customer complaints?
    - Reversed or "bad" sales?
    - Compliance problems?

Compliance Program

71. Do audit or compliance personnel:
    - Determine the scope and frequency of their own nondeposit investment sales program reviews?
    - Report their findings directly to the board of directors or an appropriate committee of the board?
    - Have their performance evaluated by persons independent of the investment product sales function?
    - Receive compensation that in no way is connected to the success of investment product sales?
    - Receive training in products and customer protection issues?
    - Keep abreast of emerging developments in banking and securities laws and regulations through ongoing training?

72. Does the bank's written compliance program call for periodic reviews to determine compliance with policies, procedures, applicable laws and regulations, and the Interagency Statement? Do those reviews cover:
    - Customer complaints and their resolution?
    - Customer correspondence?
    - Transactions with employees and directors or their business interests?
    - All advertising and promotional materials?
    - Scripts or written guidelines for oral presentations?
    - Training materials?
    - Regular and frequent reviews of active customer accounts?
    - Customer responses to suitability inquiries and a periodic comparison of those responses to the type and volume of account activity, with the goal of determining whether the activity in an account is appropriate?

73. Does the compliance program call for compliance personnel to perform continuing reviews of:
    - Changes in the system for reporting customer complaints and resolutions?
    - Changes in previously approved standard correspondence with customers?
    - New advertising and promotional materials prior to use?
    - Changes in existing training programs or new training programs?
    - Changes in incentive compensation systems?
    - New products under development?

74. Does the timing, scope, and frequency of compliance reviews consider factors such as:
    - Changes or differences in incentive compensation paid on different or new products?
    - Sales or referral contests?
    - Patterns of sales for specific, espe-

cially new, products?
- Patterns of sales to customers who have been identified as risk-averse investors?
- New salespeople?
- Customer complaints?

75. Does the bank have a system for ensuring that all complaints (written and oral) receive bank management's attention?

76. Is that system periodically tested by internal audit to determine whether bank management receives notice of all complaints?

77. Does the bank use automated exception reporting systems to flag potential compliance problems?

78. Do reports list:
    - Sales by product?
    - Significant or unusual (for the customer) individual sales?
    - Sales of products the bank considers more volatile to customers whose suitability inquiry responses indicate an aversion to risk?
    - Customer complaints by product, salesperson, and reason, so that patterns can be discerned?
    - Unusual performance by salespersons, *e.g.*, high or low volume or single product sales?
    - Significant volumes of annuity or mutual fund redemptions after short holding periods?

79. Do reports provide adequate information to conduct specific suitability reviews for customers such as:
    - Risk-averse investors?
    - First-time investors?
    - Customers with other narrow investment objectives?

80. Does the bank employ "testers" who pose as prospective customers and test the sales presentations for adherence to customer protection standards?

81. Has the bank instituted a follow-up contact program to verify whether customers understand their investment transactions?

82. Do inquiries in the follow-up contact program include discussion of the customer's:
    - Understanding of what he or she has purchased?
    - Understanding of the investment risks and the absence of deposit insurance coverage?
    - Initial responses to the salesperson's suitability inquiry?
    - Understanding of fees?
    - Problems or complaints?
    - Understanding of the bank's role in the transaction?

83. If the bank operates a follow-up contact program, are records of customers responses maintained?

Third Party Vendors

84. Has a bank officer been assigned responsibility for ensuring that the bank adequately monitors the effectiveness of customer protection systems?

85. Has the bank developed a written oversight program to monitor the activities of outside vendors operating bank-related sales programs?

86. Does the governing agreement with third party vendors include provisions regarding:
    - Training for bank employees?
    - Methods of implementing the customer protection standards contained in the bank's policy?
    - Permission for the OCC and the bank to have access to appropriate records involved in bank-related sales?
    - The scope and frequency of reports to be furnished?

87. Do reports furnished by third party

vendors include:
- A list of all new account openings and initial trades?
- A list of significant or unusual (for the customer) individual sales?
- A list of all written and oral customer complaints and their resolution?
- Sales reports by product, salesperson, and location?
- Internal compliance reviews of accounts originated at the bank?
- Copies of reports furnished to the third party vendor by their regulator?

88. Are reports furnished by a third party vendor:
    - Prepared by someone independent of the vendor's sales force?
    - Timely and sufficiently detailed?

89. Does bank management have procedures in place to avoid reliance on third party audit and control systems if the vendor's control personnel receive transaction-based incentive compensation?

90. If the product selection analysis is performed by another party, such as a clearing broker or third party vendor, does bank management understand and agree with the analysis method?

91. If customer information is provided to the third party vendor, has a legal opinion concerning the bank's authority to share customer information with third parties been obtained?

92. Has a bank officer been assigned responsibility for ensuring that adequate training is provided to bank staff, and for reviewing the hiring and training practices of any third party vendor?

Retail Nondeposit Investment Sales

Laws, Regulations and Rulings — Section 413.5

	*Laws**	*Regulations +*	*Rulings +*	*OCC and Other Issuances***
Customer disclosure requirements	15 USC 77a, 78a, and 80a	17 CFR 240 (Rule 10b-5)		Interagency Statement on Retail Sales of Nondeposit Products (February 15, 1994)
Use of common names	15 USC 80a			Interagency Statement
Investments in trust accounts	29 USC 1001 (ERISA)	9		Interagency Statement
Recordkeeping and confirmation requirements for securities transactions		12		Interagency Statement
Antifraud restrictions	15 USC 77a and 78a	17 CFR 240 (Rule 10b-5)		
Uniform guidelines				AL 93-11 and Interagency Statement
Customer protection rules	15 USC 77a, 78a, and 80a	17 CFR 240 (Rule 10b-5)		NASD Rules of Fair Practice and Interagency Statement

* 12 USC, unless specifically stated otherwise.
\+ 12 CFR, unless specifically stated otherwise.
** BC = Banking Circular, EC = Examining Circular, AL = Advisory Letter.

ONE HUNDRED THIRD CONGRESS

JOHN D. DINGELL, MICHIGAN, CHAIRMAN

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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

February 23, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20919

Dear Comptroller Ludwig:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

This is to remind you that your response to the Subcommittee's letter of January 28, 1994 was due by the close of business on Friday, February 18, 1994 and still has not been received by us. Furthermore, your cooperation is requested in providing responses to the following additional questions.

1. The Subcommittee asked MBC, Mellon Bank, and Dreyfus whether they had any enforcement actions filed against them during the past 10 years, and whether these entities had entered into any agreements with their respective regulators concerning compliance-related matters. A copy of the index to their response is enclosed. Please review it and advise the Subcommittee of any material omissions with respect to matters under your agency's jurisdiction. Also please advise us of any patterns involving compliance problems or violations about which we should be aware.

2. We note your decision to solicit public comment on this transaction as well as on the proposal of First Union Corp. of North Carolina to acquire Lieber & Associates, the manager of the Evergreen family of funds. Mellon's Legal Memorandum notes at page 36 that "[i]t has been reported that Chase Manhattan has acquired a mutual fund advisory complex, presumably with the

The Honorable Eugene A. Ludwig
Page 2

Comptroller's acquiescence or approval." Please provide the Subcommittee with a list of any and all such transactions pending before OCC or already consummated with OCC approval or acquiescence. Please explain what conditions or limitations (e.g., see the Mellon-Dreyfus Policy Statement), if any, have been imposed by OCC heretofore in connection with mergers involving advisory services and sales and marketing of mutual funds and other noninsured investment products in order to eliminate consumer confusion, protect the safety and soundness of the bank and the Federal deposit insurance funds, and for the protection of investors, and how compliance with those conditions and limitations is implemented, examined for and enforced.

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

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Comptrollar of the Currency
Administrator of National Banks
Washington, DC 20219

ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

March 3, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Dingell:

Thank you for your February 23, 1994 letter in which you request additional information to assist in your review of the proposed acquisition by Mellon Bank, N.A. (Mellon) of Dreyfus Corporation (Dreyfus). We have compiled the information you requested and are pleased to provide it to you.

I. **You have asked the OCC to review the index of enforcement actions submitted by Mellon and advise you as to whether the list is comprehensive and accurate with respect to matters under our jurisdiction. You have also asked the OCC to advise you of any patterns involving compliance problems or violations about which you should be aware.**

We have reviewed the list of enforcement actions submitted by Mellon and we believe it is accurate and complete as to matters under the OCC's jurisdiction during the past ten years. The August 11, 1992 letter of reprimand was based on repeated violations of 12 C.F.R. § 9.12(a) relating to Mellon's inadequate disclosure of its relationship to the Laurel Funds. Mellon corrected this compliance problem following the issuance of the letter of reprimand, and the OCC did not initiate any further enforcement action. The OCC is not aware of any other patterns involving compliance problems or violations.

II. **You have asked the OCC to provide you with a list of all transactions in which a national bank has acquired a mutual fund advisory business with the acquiescence and approval of the OCC. You further ask the OCC to explain what conditions or limitations have been imposed in connection with such transactions and how the OCC monitors and enforces compliance with those conditions.**

The OCC has compiled a list of all approvals granted since 1985 (the year our database began collecting such information) for national banks to engage in investment advisory

services through operating subsidiaries. (Attachment A). The list includes both acquired and de novo advisory operations in national bank operating subsidiaries. This list does not include the smaller number of national banks engaged in these activities directly through the bank or through a trust company. In general, these activities reflect expansions of trust business rather than acquisitions by the parent bank. The Chase Manhattan transaction to which you refer involved the acquisition by Chase Manhattan's Vista fund family of six funds from Olympus Asset Management, rather than the acquisition of a mutual fund advisory company. According to Lipper Analytical Services, in 1993, 113 banks or bank subsidiaries advised 943 mutual funds.

In connection with the approval of national bank acquisitions of a mutual fund advisory business, the OCC has generally imposed written conditions. The conditions set forth in Attachment "B" represent conditions that the OCC has imposed in past approvals. The OCC also approves such acquisitions subject to the representations and voluntary commitments made in the national bank's proposal and set forth in the OCC's approval letter. These types of representations and voluntary commitments are described in Attachment "C" to this response. More recent approvals also instruct the bank and its operating subsidiary to comply with Banking Circular 274, now superseded by the Interagency Statement on Retail Sales of Nondeposit Instruments.

If in the course of ongoing bank supervisory activities, OCC examiners identify instances of noncompliance with conditions, representations or commitments in an approval letter, the OCC is to require appropriate steps to correct the compliance problem. Such action can include the initiation of formal enforcement action, such as cease and desist proceedings, if the national bank violated a written condition or if it engaged in an unsafe or unsound practice. For less significant compliance problems, the OCC may use an informal action, such as obtaining the bank's written commitment to correct the identified compliance problem. Failure to abide by a condition imposed in an approval letter or a representation made or a commitment undertaken in an application could also result in a violation of 12 C.F.R. § 5.34 and subject the bank to appropriate enforcement action.

We hope this letter is responsive to your inquiry.

Very truly yours,

Eugene A. Ludwig
Comptroller of the Currency

ATTACHMENT "A"

March 2, 1994

OPERATING SUBSIDIARY APPROVALS AND PENDING CASES TO ENGAGE IN INVESTMENT ADVISORY SERVICES AND/OR MUTUAL FUNDS

Bank Name, Location

AmSouth Bank, NA, Birmingham, AL

Bank of America, San Francisco, CA

Bank of Oklahoma, NA, Tulsa, OK

Bank One, Columbus, NA, Columbus, OH

Bank One, Indianapolis, NA, Indianapolis, IN

Bank One, Milwaukee, NA, Milwaukee, WI

Chemical Bank New Jersey, NA, Morristown, NJ

Chemical Bank, NA, Jericho, NY

Commerce Bank - St. Louis, NA, Clayton, MO

Deposit Gty NB, Jackson, MS

First of America Bank Michigan, NA, Kalamazoo, MI

First Tennessee Bank, NA, Memphis, TN

First Union NB of N. Carolina, Charlotte, NC

Firstar Bank, Milwaukee, NA, Milwaukee, WI

Firstar Bank West, NA, Naperville, IL

Fleet National Bank, Providence, RI

Island NB & TC, Palm Beach, FL

Key Bank USA, NA, Albany, NY

LaSalle National Trust, NA, Chicago, IL

Mellon Bank, NA, Pittsburgh, PA

Michigan NB, Farmington Hills, MI

National Bank of Commerce Trust & Savings Assoc., Lincoln, NE

Nationsbank of Georgia, NA, Atlanta, GA

Nationsbank of N. Carolina, NA, Charlotte, NC

Northwest National Bank, Clark County, WA

PNC, Pittsburgh, PA

Society National Bank, Cleveland, OH

Union Planters National Bank, Memphis, TN

United States National Bank, Portland, OR

U.S. Bank of Washington, NA, Seattle, WA

Wells Fargo Bank, NA, San Francisco, CA

Worthen NB of Arkansas, Little Rock, AR

Zions First National Bank, Salt Lake City, UT

Notes:

- o Based on OCC records collection since 1985.
- o May include acquisitions from the bank's holding company.
- o Includes general investment advisory services.
- o Does not include operating subsidiaries acquired through bank-to-bank mergers.

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

March 3, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Dingell:

Attached is a revised list of operating subsidiary approvals and pending cases to replace the original Attachment A provided in response to your letter dated February 23, 1994. The listing is expanded to include additional de novo subsidiaries that were inadvertently omitted when our automated reports were merged.

Very truly yours,

Eugene A. Ludwig

March 2, 1994 (Revised)

OPERATING SUBSIDIARY APPROVALS AND PENDING CASES TO ENGAGE IN INVESTMENT ADVISORY SERVICES AND/OR MUTUAL FUNDS

Bank Name, Location

Amcore, NA, Sterling, IL

AmSouth Bank, NA, Birmingham, AL

Bank of America, San Francisco, CA

Bank of Oklahoma, NA, Tulsa, OK

Bank One, Columbus, NA, Columbus, OH

Bank One, Indianapolis, NA, Indianapolis, IN

Bank One, Milwaukee, NA, Milwaukee, WI

Bank IV, Kansas, NA, Wichita, KS

Barnet Bank of Jacksonville, NA, Jacksonville, FL

Belmont National Bank, St. Clairsville, OH

Chemical Bank New Jersey, NA, Morristown, NJ

Chemical Bank, NA, Jericho, NY

Citizens National Bank of Hope, Hope, AR

Colorado National Bank, Denver, CO

Commerce Bank - St. Louis, NA, Clayton, MO

Commercial National Bank in Shreveport, Shreveport, LA

Continental Bank, NA, Chicago, IL

Deposit Guaranty NB, Jackson, MS

First of America Bank Michigan, NA, Kalamazoo, MI

First Citizens National Bank, Dyersburg, TN

First Fidelity Bank, NA, Salem, NJ

First National Bank & Trust Co., Ada, Ada, OK

First National Bank of Effingham, Effingham, IL

First National Bank of Maryland, Baltimore, MD

First National Bank of Phillips County, Helena, AR

First National Bank, San Diego, CA

First National Bank & Trust Co. of Rochelle, Rochelle, IL

First Tennessee Bank, NA, Memphis, TN

First Union NB of N. Carolina, Charlotte, NC

Firstar Bank, Milwaukee, NA, Milwaukee, WI

Firstar Bank West, NA, Naperville, IL

Fleet National Bank, Providence, RI

Founders National Trust Bank, Fort Meyers, FL

Hawkeye Bank of Dubuque, NA, Dubuque, IA

Island NB & TC, Palm Beach, FL

Key Bank USA, NA, Albany, NY

LaSalle National Trust, NA, Chicago, IL

Liberty National Bank & Trust Co., Kentucky, Louisville, KY

Mellon Bank, NA, Pittsburgh, PA

Mercantile National Bank, Los Angeles, CA

Merchants National Bank of Fort Smith, Fort Smith, AR

Michigan NB, Farmington Hills, MI

Michigan Avenue National Bank, Chicago, IL

National Bank of Commerce, Memphis, TN

National Bank of Commerce Trust & Savings Assoc., Lincoln, NE

National City Bank, Indiana, Indianapolis, IN

National City Bank, Kentucky, Louisville, KY

Nationsbank of Georgia, NA, Atlanta, GA

Nationsbank of N. Carolina, NA, Charlotte, NC

Natwest Bank USA, New York, NY

Northwest National Bank, Clark County, WA

PNC, Pittsburgh, PA

Resource Bank, NA, DeKalb, IL

Riggs National Bank of Washington, Washington, DC

Rockwell Bank, NA, Oklahoma City, OK

Society National Bank, Cleveland, OH

Southern National Bank of North Carolina, Lumberton, NC

Southtrust Bank of Alabama, NA, Birmingham, AL

Third National Bank in Nashville, Nashville, TN

Union Planters National Bank, Memphis, TN

United States National Bank, Portland, OR

U.S. Bank of Washington, NA, Seattle, WA

Wells Fargo Bank, NA, San Francisco, CA

Worthen NB of Arkansas, Little Rock, AR

Zions First National Bank, Salt Lake City, UT

Notes:

- Based on OCC records collection since 1985.
- May include acquisitions from the bank's holding company.
- Includes general investment advisory services.
- Does not include operating subsidiaries acquired through bank-to-bank mergers.

ATTACHMENT "B"
CONDITIONS THAT THE OCC HAS IMPOSED IN CONNECTION WITH NATIONAL BANK MUTUAL FUND ACTIVITIES

(1) The Banking Entity[1] shall disclose that the investment products sold (a) are not FDIC insured; (b) are not obligations of the bank; (c) are not guaranteed by the bank; and (d) involve investment risks, including possible loss of principal. These disclosures shall be in the same or substantially similar language to the language above. The Banking Entity shall obtain at the time an investment account is established a signed statement acknowledging that the customer has received and understands these disclosures.

(2) The disclosures described in (1) above must also be conspicuously disclosed to customers in all written sales presentations, advertising and promotional materials, confirmation forms, and periodic statements.

(3) The Banking Entity shall provide full disclosure to customers at the time the investment account is established explaining the relationships between the national bank, its operating subsidiary(ies), and any other entities participating in the mutual funds business.

(4) The Banking Entity may not offer uninsured investment products with a name identical to the bank. The investment products may not be marketed in a manner that would mislead or deceive customers as to the products' uninsured nature and lack of any guarantee by the bank.

(5) The Banking Entity must maintain an operations manual and other written materials addressing the conduct of retail sales activities, which will be made available for OCC review. The materials must emphasize customer suitability judgment procedures and compliance with 12 C.F.R. Part 9.

(6) The operating subsidiary will be adequately capitalized.

(7) The Banking Entity will be managed to minimize the risk of piercing the corporate veil.

(8) The partnership agreement, if any, will fully delineate the activities of the partnership.

(9) The bank, through its operating subsidiary, will have veto power over the activities of a partnership and any of its major decisions.

(10) The Banking Entity will be subject to OCC regulation, supervision, and examination.

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[1]The term "Banking Entity" may refer to the national bank, its operating subsidiary, and/or a partnership in which the subsidiary participates as a partner depending on the corporate structure through which the bank engages in mutual fund advisory activities.

(11) The bank's aggregate direct and indirect investments in and advances to the operating subsidiary and/or partnership shall not exceed an amount equal to the bank's lending limit.

(12) The Banking Entity will not be obligated or committed to extend credit to any customer of the partnership for purposes of purchasing any product through the partnership. All credit so extended will be on an arm's length basis and consistent with safe and sound banking.

(13) The bank must submit a notice to the OCC pursuant to 12 C.F.R. § 5.34 if the operating subsidiary and/or partnership at some future time decides to engage in new activities, i.e. activities not covered by the bank's notice and the OCC's response thereto. Such a submission must be made even through the activities have been found to be permissible for national banks.

ATTACHMENT "C"
REPRESENTATIONS AND VOLUNTARY COMMITMENTS MADE BY NATIONAL BANKS IN CONNECTION WITH APPROVALS OF MUTUAL FUND ACTIVITIES

(1) The Banking Entity[1] will comply with disclosure obligations as contained in the Interagency Statement (superseding BC-274).

(2) The Banking Entity will not manage customer accounts on a discretionary basis.

(3) The Banking Entity will not engage in the underwriting of securities and will not deal in securities.

(4) The Banking Entity will not purchase securities for its own accounts except to the extent that national banks are permitted to do so under applicable law.

(5) The Banking Entity will not extend credit to any mutual funds made available by the subsidiary.

(6) The Banking Entity will make all appropriate disclosures and otherwise comply with federal securities laws and the NASD Rules of Fair Practice.

(7) The mutual funds will be sponsored by third parties independent of the bank, the subsidiary and affiliates thereof.

(8) Mutual funds will be controlled by their board of directors and not by the bank serving as investment advisor.

(9) The Banking Entity will not offer uninsured investment products with a name identical to the bank.

(10) The Banking Entity's investment products will not be marketed in a manner that would mislead or deceive consumers as to the uninsured nature and lack of a guarantee.

(11) The employees of the Banking Entity will sever any preexisting employment ties with the national bank, its operating subsidiary or any mutual fund company. There will be no dual employment.

(12) Banking Entity will be a registered broker-dealer under Securities Exchange Act of 1934 and state securities laws

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[1]The term "Banking Entity" may refer to the national bank, its operating subsidiary, and/or a partnership in which the subsidiary participates as a partner depending on the corporate structure through which the bank engages in mutual fund advisory activities.

(13) The Banking Entity will register as an investment advisor under the Investment Advisors Act of 1940.

(14) Banking Entity will be an NASD member.

(15) The Banking Entity's mutual fund business will be physically separate from that of the bank with separations (plants, partitions separating it from the bank), separate signs and logos to identify offices, and separate telephone numbers.

(16) The bank's aggregate direct and indirect investments in and advances to the operating subsidiary and/or partnership shall not exceed an amount equal to the bank's lending limit.

(17) The Banking Entity will not be obligated or committed to extend credit to any customer of the partnership for purposes of purchasing any product through the partnership. All credit so extended will be on an arm's length basis and consistent with safe and sound banking.

(18) Customer lists of partnership, if any, will be kept confidential. Nonbanking partner will not have access to bank customer lists.

(19) The Banking Entity will not provide brokerage services to bank's trust customers except where explicitly authorized and in accordance with applicable law.

ONE HUNDRED THIRD CONGRESS

JOHN D. DINGELL, MICHIGAN, CHAIRMAN

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REID P.F. STUNTZ, STAFF DIRECTOR/CHIEF COUNSEL

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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 2, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20919

Dear Comptroller Ludwig:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

This is with reference to your letter of February 25, 1994 responding to a series of questions that the Subcommittee posed in connection with our letter of January 28, 1994. The OCC response seemed to rewrite some of the questions and not respond at all to others. In order to assist the Subcommittee in its review, we respectfully request that you provide accurate and complete responses in writing by the close of business on Friday, March 18, 1994. The numbers refer to the original numbers in the Subcommittee's January 28th letter.

1.a. Your letter was somewhat vague in its response to question 1.a., in which the OCC was asked to compare the Federal Reserve Board's capital treatment of Section 20 affiliates of a bank holding company with the OCC's capital treatment of securities subsidiaries of national banks. There appear to be real differences between these two methods. In particular, with respect to each of the two methods, please discuss whether the parent's capital investment in the subsidiary is included in meeting the parent bank or holding company's regulatory capital standards. In addition, please explain the differences in these two methods, including the impact on double leverage, if any.

Moreover, your letter did not discuss at all how the FDIC treats a bank's investment in a securities subsidiary for capital purposes (which may be more comparable in that it involves a

The Honorable Eugene A. Ludwig
Page 2

direct bank-subsidiary relationship). Please include this comparison in your response.

1.b. With respect to question 1.b., as a legal matter, is the capital of Dreyfus' broker-dealer subsidiary separate from the capital of the parent bank? Your response states that: "The OCC would not permit Mellon to withdraw capital from Dreyfus so as to leave its subsidiary undercapitalized." Please explain under what circumstances the OCC would permit Mellon to withdraw capital from a registered broker-dealer subsidiary?

2. With respect to enhanced controls, your answer appears to suggest that any such controls need to be based on the unique facts and circumstances of a bank's participation in the mutual fund business, rather than uniform controls. For example, the OCC could require all bank securities activities to be effected in registered subsidiaries, but has chosen not to take such a uniform approach. Why is that the case, and doesn't it make bank regulation and examination needlessly complex? (Requiring more examiners for more facts-and-circumstances regulations, etc.)

3. Please support and explain how Dreyfus would be "the bank...agent, or other person participating in the affairs of such bank" within the scope of 12 U.S.C. section 1818(b).

4. As argued by the OCC, anything that is "incidental to banking" is not proscribed by the Glass-Steagall Act. Notably, in the 1970's, the OCC argued that running a travel agency in a bank was "incidental to banking." (The OCC lost.) More recently, in the context of the VALIC case, the OCC has argued that annuities are not insurance and that they are "incidental to banking" because they are the functional equivalent of an investment product sold by a bank (a CD), even though they are commonly regulated by state insurance departments. (The OCC has lost in the 5th Circuit, and is trying to get the Solicitor General to ask for cert in this case.)

Thus, using the OCC's legal theory, it is conceivable that the OCC could determine that underwriting was a financial service that was "incidental to banking," and it would follow that the Glass-Steagall Act would not apply to bank underwriting activities. Please comment.

6. Your letter states that the OCC is examining bank subsidiaries that are registered broker-dealers. Does the OCC alert the SEC in advance to such exams and routinely share examination results? Why not?

6.a. Please provide examination guides for compliance with Sections 23A and B, and explain how Mellon's voluntary compliance with Sections 23A and B will be examined for and enforced.

The Honorable Eugene A. Ludwig
Page 3

6b. and c. The OCC states that it will pursue formal enforcement actions against bank sales personnel only if such actions threaten the safety and soundness of the bank or involve a violation of law. How will bank customers be able to obtain redress if the OCC does not pursue violations of the Interagency Guidelines, and no avenue exists for customer private rights of action or arbitration of bank customer disputes?

7. Please explain what the OCC means by an "appropriate suitability requirement" and how it differs from the NASD's suitability requirements.

9. Please state whether any of the distributor's activities will be subcontracted to Mellon or Mellon subsidiaries or affiliates. Since the distributor is not itself selling mutual fund shares, who is underwriting the issuance of Dreyfus' mutual fund shares?

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 24, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S House of Representatives
Washington, DC 20515-6116

Dear Chairman Dingell:

Thank you for your March 2, 1994 letter in which you ask certain follow up questions to our February 25, 1994 letter concerning the proposed acquisition by Mellon Bank, N.A. ("Mellon") of Dreyfus Corporation ("Dreyfus"). We have endeavored to provide you with the requested information. The numbered answers below correspond to the questions in your letter.

1a. **You have asked the OCC to compare the Federal Reserve's capital treatment of Section 20 subsidiaries with the OCC's capital treatment of securities subsidiaries. In particular, with respect to both methods, you would like to know whether the parent's capital investment in the subsidiary is included in meeting the parent bank or holding company's regulatory capital standards. You further ask us to explain the differences in these two methods, including the impact of double leverage, if any. Finally, you ask us to discuss how the FDIC treats a bank's investment in a subsidiary for capital purposes.**

For operating subsidiaries that engage only in bank permissible activities, the Federal Reserve, the FDIC, and the OCC require the institutions they regulate to consolidate the assets and liabilities of its operating subsidiary and to hold capital against the consolidated assets as provided by GAAP. Thus, the OCC, Federal Reserve, and FDIC also permit the parent bank to count its investment in such a subsidiary toward meeting the higher capital requirement that results from the consolidation of assets. There is no double leverage in the sense of failing to include assets corresponding to capital while including the capital itself in any of the bank capital tests. There is also no double leverage in the sense of using a subsidiary's capital simultaneously to address distinct risks arising from the activities of a subsidiary and its parent. Consolidated bank capital standards assume banks are engaged in all permissible activities, including securities activities.

The Federal Reserve and the FDIC apply a different rule to securities subsidiaries that engage in underwriting. The Federal Reserve applies the risk-based capital test to a holding company under two different standards. It applies the test to the parent with the assets and capital of its Section 20 subsidiary included (including the parent's investment in the subsidiary) and applies the test again after subtracting the subsidiary's asset and capital from the parent's balance sheet. In addition, the holding company, including the capital investment in the Section 20 subsidiary, must meet the minimum leverage test.

The Federal Deposit Insurance Corporation ("FDIC") applies both the risk-based and leverage capital test to nonmember state banks without consolidating assets and capital of bona-fide securities subsidiaries that engage in underwriting. Twelve U.S.C. § 325.5(c) provides that the assets and liabilities of a securities subsidiary of a state bank shall not be consolidated with its bank parent and any investment therein shall be deducted from the parent's Tier 1 capital and total assets. The deduction of the parent's investment in the subsidiary is linked to the nonconsolidation of the subsidiary's assets and liabilities.

1b. You ask whether the capital of Dreyfus' broker-dealer subsidiary would be legally separate from the capital of the parent bank. You also question under what circumstances the OCC would permit Mellon to withdraw capital from a registered broker-dealer subsidiary.

Upon acquisition, the capital of a national bank operating subsidiary is consolidated with that of the parent bank for reporting purposes. While the capital of the two entities may be held in separate accounts, those capital accounts are not totally segregated. Once a national bank acquires an operating subsidiary, excess capital of either the bank or the subsidiary may be moved to the other as necessary. Nevertheless, the national bank is required to ensure that both the bank itself and its operating subsidiary meet their regulatory capital requirements. Thus, a national bank would not be permitted to withdraw capital from the subsidiary and leave it undercapitalized for regulatory purposes. Such an action would constitute a violation of law or regulation, an unsafe and unsound practice, and a violation of a written commitment (if such a condition were included in the approval letter). In other words, the operating subsidiary must maintain the same minimum capital it is required to hold on a stand-alone basis.

2. You question whether the enhanced controls discussed in our letter should be based on the unique circumstances of a bank's mutual funds business or more uniform standards.

The OCC requires national banks in the mutual funds business to comply with applicable uniform guidelines and controls as well as others specifically tailored to the institution and the level of business. For example, the Interagency Statement on Retail Sales of Nondeposit Investments ("Interagency Statement") sets forth the uniform guidelines and controls required of national banks participating in the mutual funds business. In addition, the OCC has required particular procedures and controls necessary to implement these guidelines that vary according to the nature of the bank's mutual fund sales activities. Thus, the OCC relies on both uniform

and bank specific controls to provide for effective and efficient regulation of national bank mutual fund sales activities. The OCC routinely reviews, and is currently reviewing the conditions of approval it imposes on similar operating subsidiary applications to determine which conditions the agency should consider imposing uniformly through rulemaking without unduly increasing regulatory burden.

3. **You ask the OCC to support and explain the statement that Dreyfus would be "the bank. . . agent, or other person participating in the affairs of such bank" within the scope of 12 U.S.C. § 1818(b).**

Twelve U.S.C. § 1818(b) gives the OCC jurisdiction to initiate cease and desist proceedings against "any insured depository institution, depository institution which has insured deposits, or any institution-affiliated party." This language replaced the "participating in the affairs of the bank" language after the enactment of the Financial Institution, Reform, Recovery and Enforcement Act of 1989.

This broad jurisdiction authorizes the OCC to initiate enforcement proceedings against a national bank if the bank or its operating subsidiary participates in a violation of law, an unsafe or unsound practice, or a violation of a written agreement. In this sense, operating subsidiaries are treated as divisions or departments of their parent insured depository institutions. OCC regulations provide that "[u]nless otherwise provided by statute or regulation, all provisions of the Federal banking laws applicable to the operations of the parent bank shall be equally applicable to the operations of its operating subsidiary." 12 C.F.R. § 5.34(d)(2). Operating subsidiaries also are subject to the examination and supervision of the OCC. 12 C.F.R. § 5.34(d)(3). If, therefore, the OCC determines that the subsidiary has operated in an unsafe and unsound manner or has violated the law or a written condition, then the OCC may order the bank to take remedial action under 12 U.S.C. § 1818, including disposal of the subsidiary. See 12 C.F.R. § 5.34(d)(3).

4. **You ask whether it is conceivable that the OCC would determine that underwriting was a financial service "incidental to banking," and whether it would follow that the Glass-Steagall Act would not apply to bank underwriting activities.**

The Glass-Steagall Act specifically provides that national banks "shall not underwrite any issue of securities or stock." 12 C.F.R. § 24(7). This specific prohibition makes it clear that such underwriting is not a permissible banking activity. In contrast, the sale of annuities, which the OCC argues is incidental to the business of banking, is not specifically proscribed by Glass-Steagall. Indeed, we note that the Glass-Steagall Act expressly permits banks to sell securities as agent. See 12 U.S.C. § 27(7).

6. **You ask whether the OCC alerts the SEC prior to examining bank operating subsidiaries registered as broker-dealers and whether we routinely share examination results.**

The OCC has invited the SEC to participate in joint examinations of banks' operating subsidiaries involved in mutual fund sales activities. The OCC and SEC staffs have discussed developing general guidelines for handling these examinations. The OCC shares examination information and materials with the SEC upon request and refers violations of law identified during examinations to the SEC as appropriate.

6a. You have asked the OCC to provide examination guides for compliance with Sections 23A and 23B and explain how Mellon's voluntary compliance with those sections will be examined for and enforced.

We have attached for your review those sections of the Comptroller's Handbook for National Bank Examiners that discuss compliance with Sections 23A and 23B of the Federal Reserve Act. If OCC examiners reviewing transactions between the bank and its subsidiary identify noncompliance with the voluntary commitments made in connection with an operating subsidiary approval, the OCC could initiate enforcement action to correct problems, including formal enforcement action for the violation of the written condition or an unsafe or unsound practice.

Mellon has represented that it would not object if its voluntary commitments, such as the commitment to comply with Sections 23A and 23B, were included as conditions of approval. If the OCC were to approve this proposed acquisition, it would likely include, at a minimum, the written conditions set forth in the policy statement.

6b&c. You have asked how bank customers will obtain redress for violations of the Interagency Statement.

The OCC has previously stated that it will take action to correct violations of the Interagency Statement or other compliance problems identified during an examination. The OCC would consider initiating formal action if the misconduct constituted a violation of law, an unsafe or unsound practice, or a violation of a written commitment. For less serious violations, the OCC would use informal enforcement remedies, such as obtaining management's written commitment to correct the identified problem. Further noncompliance could then subject the bank to formal action.

While the Interagency Statement does not include a private right of action, customers seeking redress have other ways to seek relief. If the violation of the Interagency Statement constitutes fraud, for example, the customer may have a private right of action under section 10(b) of the Securities Exchange Act of 1934. The customer may also forward the complaint to the OCC for investigation and possible enforcement action. If the OCC initiates formal enforcement action based on a customer complaint, the OCC has broad remedial authority, including the authority to seek reimbursement for the aggrieved customer(s) in appropriate circumstances.

Trade associations for the banking industry recently joined together to publish guidelines on retail investment sales by banks. Those guidelines provide that banks may wish to resolve disputes with customers involving securities transactions through arbitration. The publication

includes sample arbitration forms to use in such disputes. The OCC supports arbitration as a dispute resolution mechanism.

7. You have asked us to explain what we mean by an "appropriate suitability requirement" and how it differs from the NASD's suitability requirements.

The OCC used the term "appropriate suitability requirement" in reference to the suitability requirement contained in the Interagency Statement. That requirement is substantially similar to the one contained in the NASD Rules of Fair Practice. The difference between the two provisions relates to the suitability analysis required of sales personnel in connection with the sale of money market mutual funds. The Interagency Statement requires bank sales personnel to make reasonable efforts to obtain customer information including the customer's financial status, tax status and investment objectives to support the suitability analysis. The NASD Rules specifically exempt money market mutual funds from this requirement.

9. You have asked whether any of the distributor's activities will be subcontracted to Mellon or Mellon subsidiaries or affiliates. You further ask who is underwriting the issuance of Dreyfus' mutual fund shares.

The Notice does not suggest that any of the distributor's activities will be subcontracted to Mellon or Mellon subsidiaries or affiliates. Mellon has also represented in a letter to you dated February 18, 1994 that it does not contemplate that the third party distributor will subcontract any services to any Mellon entity. Mellon has also represented that neither Mellon nor Dreyfus would underwrite shares. The Notice does not involve any entity that would make a firm commitment to purchase a fixed number of shares at a fixed price from the issuer, and would arrange separately for the sale of purchased shares to the public.

I hope this information is useful to you. If you have any further questions, please contact me at (202) 874-4900 or David Apgar at (202) 874-4890.

Very truly yours,

Eugene A. Ludwig

Eugene A. Ludwig
Comptroller of the Currency

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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 2, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20919

Dear Comptroller Ludwig:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

In connection with the Subcommittee hearings today and tomorrow on this matter, serious concerns have been raised regarding the adequacy of the protections that the banking laws afford customers who purchase securities or investment advice in banks. Accordingly, I am transmitting the enclosed 55-page draft table comparison of the regulation of broker-dealers and investment advisers under the federal securities laws versus under the federal banking laws. The table summarizes the principal relevant statutes, regulations, and guidelines administered by the Securities and Exchange Commission and by the federal banking agencies. The Subcommittee will be keeping the hearing record open for 30 days to accommodate our request that you carefully review this document and submit any corrections you deem necessary to make this table accurate and complete.

If you have any questions about this request, please contact Consuela M. Washington of the staff at (202) 225-3147. Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

Enclosure

cc: The Honorable Dan Schaefer

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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 31, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20919

Dear Comptroller Ludwig:

This is with reference to the Subcommittee's letter of March 2, 1994 asking you to review our draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and under the federal banking laws. The table does not include all the federal securities laws and rules, nor does it address the regulation of banks as transfer agents, municipal, or government securities dealers. This is consistent with the scope of the Subcommittee's inquiry as well as the table's stated scope.

At the request of the Office of the Comptroller of the Currency, we are extending the deadline for your responses to the close of business on Friday, April 8, 1994, at which time we will be closing the hearing record and taking the steps to go to prompt printing. It would be helpful if the recipients of the March 2 letter would meet and discuss (and where possible coordinate) your responses. In any event, your transmittal letters for your corrections should indicate the name and phone number of a contact person on your staff, in the event that we have questions about your submission.

The Subcommittee greatly appreciates your cooperation and assistance with our work. We firmly believe that these issues are of vital importance to the protection of the public.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer
The Honorable Alan Greenspan
The Honorable Andrew C. Hove
The Honorable Arthur Levitt

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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

May 10, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S. W.
Washington, D. C. 20219

Dear Comptroller Ludwig:

This is in reference to your letter of April 8, 1994 transmitting a memorandum from your Chief Counsel commenting on our draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and the federal banking laws.

To the extent that your comments suggest substantive corrections, we are making the necessary revisions to the final table and greatly appreciate your assistance. In some cases, however, your staff memorandum raises points that are already noted in the table or are beyond its scope. Finally, we would note that the final table will not reflect your memorandum's pejorative comments about securities self-regulatory organizations (SROs) and the status of SRO rules and disciplinary proceedings under the federal securities laws, nor its objection to the comparison of securities regulation with bank regulation, or its suggestion that the use of similarly highly detailed regulations by federal thrift regulators led to the S&L crisis. We would be pleased to consider these views in the context of the debate surrounding functional regulation, and, if it is true that only a small percentage (13-15 percent) of securities sales in banks occur outside the registered broker-dealer framework, such a comparison would be highly relevant. We regret the decision of your Chief Counsel (noted on page 11 of the memorandum) to render less than total cooperation due to his decision that the stipulated comparison of securities and banking law protections was inherently biased.

In connection with our review of the OCC's comments, the Subcommittee requests your responses to the following by the close of business on Friday, May 20, 1994 so that we may complete our edits to the comparison table:

1. The OCC memorandum cites 12 C.F.R. Part 9 in numerous places as providing customer protection to investors who purchase securities through banks. For example, in commenting on section I.D of the table (sales practices), the OCC memorandum notes that "OCC regulation 9.7(d), 12 C.F.R. § 9.7(d), provides that every national bank exercising fiduciary powers shall adopt written policies and procedures to ensure compliance with the Federal securities laws in connection with any decision or recommendation to purchase or sell any security." (OCC Memorandum at 7) The OCC memorandum also cites Part 9 in commenting on the registration, Chinese walls, recordkeeping and confirmation, and examination requirements applicable to bank brokerage activities.

The Subcommittee has reviewed the Interagency Statement and OCC Bulletin 94-13, and has researched OCC letters authorizing brokerage activities for national banks. We do not know of any instance in which the OCC determined that such activities require approval as fiduciary activities subject to 12 U.S.C. 92a and 12 C.F.R. Part 9.[1] Moreover, we are not aware of any OCC requirement that a customer enter into a trust agreement with a bank prior to brokerage services being made available. We therefore request that you provide citations to orders or releases in which the OCC has advised banks that their brokerage activities are subject to section 92a and 12 C.F.R. Part 9.

2. Your letter cites an OCC proceeding, <u>In the Matter of Thelma Elizabeth Pollard</u> (1992), as an example of the OCC's use of 12 C.F.R. § 1818 to reach violations of the antifraud provisions of the federal securities laws.

We are aware that the SEC filed and settled a complaint against Ms. Pollard for violation of section 17(a) of the Securities Act of 1933 in October 1991. (<u>See</u> SEC Litigation Release No. 13033, Oct. 9, 1991.) The SEC alleged that Ms. Pollard prematurely "broke" bank customers' time deposits and invested the funds, without the customers' knowledge or consent, in commercial paper of the bank's holding company.

Subsequently, the OCC initiated civil money penalty and removal and prohibition proceedings against Ms. Pollard pursuant to § 1818 on December 4, 1991. Ms. Pollard entered into a stipulation and consent order with the OCC on May 19, 1992. (<u>See</u> 1992 OCC Enf. Dec. No. 625.) On the basis of OCC records avail-

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[1] In this connection, we note that the OCC memorandum states that the "OCC has developed two distinct cadres of examiners who specialize in securities activities and in fiduciary activities." (OCC Memorandum at 3) This statement appears to acknowledge that national bank brokerage activities are separate from the trust function. If not, please amplify and clarify.

The Honorable Eugene A. Ludwig
Page 3

able through LEXIS and similar research sources, however, we cannot determine what charges the OCC brought against Ms. Pollard, or what Ms. Pollard stipulated to in the May 1992 order. Accordingly, we request that you provide the Subcommittee with a copy of the record in the OCC's Pollard case. In addition, we request that you describe those respects in which the OCC's action overlapped with or differed from the SEC's action of an earlier date.

3. Please provide the Subcommittee with copies of: the Comptroller's Handbook for National Banks, the Comptroller's Handbook for Compliance, and the Comptroller's Handbook for Fiduciary Activities.

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

Enclosure

cc: The Honorable Dan Schaefer

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

June 1, 1994

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515-6115

Dear Chairman Dingell:

I am responding to your May 10, 1994, letter in which you requested additional information and clarifications concerning the Subcommittee's comparison chart of the treatment of broker-dealers and investment advisers under the federal securities laws. The numerical references in our responses below correspond to those used in your May 10 letter.

1. You have asked if the OCC has determined whether brokerage activities require approval as fiduciary activities subject to 12 U.S.C. § 92a and 12 C.F.R. Part 9. When a national bank simply provides brokerage services, without exercising investment discretion or furnishing investment advice, the bank is not considered to be engaging in fiduciary activities. However, when brokerage activities are combined with investment discretion or investment advice, the requirements of 12 U.S.C. § 92a and 12 U.S.C. Part 9, relating to the exercise of trust powers, become applicable. You have also asked that we provide citations to orders or releases in which the OCC has advised banks that their brokerage activities are subject to section 92a and 12 C.F.R. Part 9. <u>Attachment I</u> contains copies of several orders and releases where the OCC has advised banks conducting securities brokerage activities in conjunction with investment advisory activities that they must comply with these provisions.

   - Decision of the Comptroller of the Currency on Application from American National Bank of Austin, Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice, [1983 - 1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,732.

   - Letter to R.C. Gallagher, President, Kellog-Citizens National Bank of Green Bay from Judith A. Walter, Senior Deputy Comptroller for National Operations, [1985 - 1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,540.

- Letter dated July 30, 1985 from Deborah S. Hechinger, Director, Securities & Corporate Practices Division, [1985 - 1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,523.

In footnote 1 of your letter you ask whether because the OCC has developed two distinct cadres of examiners who specialize in securities activities and in fiduciary activities this is an acknowledgment by the OCC that national bank securities activities are separate from the trust function. As the letters cited above indicate, the OCC does not view these activities as separate. It is correct to say, however, that where the OCC believes that specialized expertise is required to improve the examination process, the agency utilizes its resources to acquire the specialized expertise that is needed.

2. You have requested that we provide you with the record for <u>In the Matter of Thelma Elizabeth Pollard</u> (1992). <u>Attachment II</u> consists of the Notice of Charges ("Notice") and Stipulation and Consent Order ("Order") for the <u>Pollard</u> case. Since the case settled at an early stage, I am transmitting the Notice rather than the full record, because the Notice fully describes the OCC's action and the record is voluminous and contains material not relevant to your inquiry.

You have asked us to describe those respects in which the OCC's action overlapped with or differed from the SEC's action of an earlier date. Both actions were similar, and concerned allegations of securities fraud. Our action was brought under 12 U.S.C. § 1818(e) and alleged violations under § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), stemming from the fraudulent transfer of customer funds from deposit instruments, including federally insured certificates of deposit, and the sale of commercial paper issued by the subject issuing bank's holding company without the customer's knowledge, authority or consent. The SEC's action also alleged violations under § 17(a).

The OCC imposed and collected a civil money penalty from Ms. Pollard, and for a two year period from the date of settlement of the case, prohibited her from engaging in activities with or related to depository institutions, as noted on pages 3-5 of the Order. The SEC's release indicates that the SEC entered a final judgment permanently enjoining Ms. Pollard from violations of Section 17(a) of the 1933 Act.

3. <u>Attachment III</u> contains copies of the following requested materials --

- Comptroller's Handbook for National Banks

- Comptroller's Handbook for Compliance

- Comptroller's Handbook for Fiduciary Activities

I hope these clarifications and materials provide you and your staff with the information you are seeking. Should you need any additional information, please let me know.

Sincerely,

Eugene A. Ludwig
Comptroller of the Currency

Attachments

ONE HUNDRED THIRD CONGRESS

JOHN D. DINGELL, MICHIGAN, CHAIRMAN

SHERROD BROWN, OHIO
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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 17, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20919

Dear Comptroller Ludwig:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation whereby Dreyfus will be acquired by Mellon Bank, N.A. as a separate operating subsidiary.

In connection with your testimony at the Subcommittee hearing on March 3, 1994, this is to request that you provide for inclusion in the record the following responses, information and documents by the close of business on Thursday, March 31, 1994.

1. Please support and explain your interpretation (Tr. pp.30-33) that 12 CFR Part 9 protects investors in a mutual fund or purchasers of other securities in a bank. Mutual funds obviously are not the trusts or estates contemplated by Part 9. How are they encompassed within the definitions of "account," "fiduciary," and "fiduciary powers" in 12 CFR § 9.1(a), (b), and (c)? As requested (Tr. pp. 32, 33), please cite and explain every instance where you have used Part 9 in connection with misbehaviors in connection with mutual fund sales.

2. You were asked (Tr. p. 34) whether OCC had ever sanctioned any bank for any impropriety in connection with mutual fund sales. You responded that you had required banks to change their practices. For the period during which the OCC has permitted national banks to sell mutual funds and other securities, please provide for the record a list, with an explanation of the alleged wrongdoing and the sanction applied, of OCC enforcement actions where sanctions have been applied against banks or their employees in connection with mutual fund sales. If there are none, so state.

Provide similar information where OCC merely has required the violators to change their practices.

3. As requested (Tr. p. 36), please provide copies of the 14 consumer complaints filed with OCC last year involving mutual funds. Please advise us of the final disposition of these complaints. With respect to the seven complaints that resulted in restitution to the customer (Tr. p. 144), please describe the nature of the violation involved, and whether restitution was voluntarily offered, or was required by the OCC.

4. As requested (Tr. pp. 45, 49), please provide information on how many instances and involving what program areas or violations (i.e., fraud against customers, insider trading, etc.) OCC has made enforcement referrals to the SEC. Please explain your policy in this area and provide us with copies of any written guidelines.

5. As requested (Tr. p. 63), please advise the Subcommittee how many banks have a suitability program, what these programs entail, how they are examined and enforced, and how these programs differ from the requirements of the NASD suitability rule (see NASD Manual -- Rules of Fair Practice, Art. 111, § 2 ¶ 2152 (Recommendations to Customers)). Please inform us (Tr. p. 65) whether all 300 banks examined by OCC this year have adopted the NASD requirements as their program, and, if not, how many have done so.

6.a. You testified (Tr. p. 112) that 12 USC § 1818 authorized OCC to enforce the federal securities laws and the rules and regulations thereunder. Please support and explain that statement. In particular, please explain how violations of the federal securities laws by a bank, its securities subsidiary, or a third party broker-dealer can be considered "unsafe and unsound banking practices." Also, please advise whether any court has ever considered 12 USC 1818 to reach violations of the federal securities laws and the rules and regulations thereunder.

b. As requested (Tr. p. 137), please submit a report on all the actions taken by OCC against banks or their employees for violations of the federal securities laws. Please segregate cases brought against banks in their capacity as municipal securities and government securities dealers, and as transfer agents, and those where the violations involve bank mutual fund or securities sales. Your report also should, by reference to the attached table from the SEC's annual report to Congress, explain in general the persons subject to, acts constituting, and basis for the enforcement action as well as what sanctions OCC can bring to bear. Please

The Honorable Eugene A. Ludwig
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compare and contrast your investor protection enforcement program with the program administered by the SEC.

c. Please submit for the record, as requested (Tr. pp. 146, 147), copies of the specific rules that OCC has with regard to the rights (e.g., arbitration, private rights of action) of aggrieved individuals in connection with bank securities activities, and explain the application of these remedies. Please state for the record whether it is the position of the OCC that the National Bank Act pre-empts the application of the federal securities laws, and, in particular, the OCC's view on Simpson v. Mellon Bank, NA (ED. Pa. 1993).

d. SEC enforcement actions are made public by the preparation of litigation releases (sample copy enclosed) which are publicized under news releases (significant cases are then reported in the press) and by publication in the weekly SEC Docket (sample copy enclosed). The NASD maintains an 800-number that allows the public to check on a registered broker-dealer's disciplinary history before making a decision to do business with him. Moreover, the self-regulatory organizations, i.e., the exchanges and the NASD, are required to discipline their members and, as you may have observed, those actions are reported in the Wall Street Journal and New York Times. We have established this system so that customers can protect themselves in part by having access to the enforcement and disciplinary histories of broker-dealers. Please advise us of the OCC's program in this regard, providing us with copies for the record of the documents you publish on OCC enforcement actions in connection with bank sales of mutual funds or other securities. If you have no such program, please so state. How can a potential customer find out if there is a pattern of examiner requests that a particular bank or its employees "change their practices" (Tr. p. 34) in this area?

7. As requested (Tr. p. 134), please submit a report on the progress of the OCC and SEC in coordinating your respective examination and enforcement programs. Your report should include a list of the dates, participants, and summaries of any and all interagency meetings on this subject, and copies of any memoranda of understanding between OCC and SEC with respect to the terms and conditions of such joint examination and enforcement programs. Are there any joint enforcement efforts currently pending between the SEC and the OCC?

The Honorable Eugene A. Ludwig
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If you have any questions about this request, please contact Consuela M. Washington of the staff at (202) 225-3147. Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

Enclosures

cc: The Honorable Dan Schaefer

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 8, 1994

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
U.S. House of Representatives
Washington, DC 20515-6116

Dear Mr. Chairman:

Thank you for your letter of March 17, 1994, in which you requested additional information on issues arising from the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation. We have endeavored to provide you with the requested information.

1. **How does 12 C.F.R. Part 9 ("Part 9") protect investors in a mutual fund or purchasers of other securities in a bank? Has the OCC ever used its 12 C.F.R. Part 9 ("Part 9") authority to protect investors in a mutual fund or purchasers of other securities in a bank?**

Part 9 protects investors as well as trust customers who receive investment advice and purchase mutual funds or other securities from a national bank or its employees. National banks that provide investment advice must first apply to and receive authorization from the OCC to exercise fiduciary powers pursuant to 12 U.S.C. § 92a. *See, e.g.*, Decision of the Comptroller of the Currency Concerning an Application by American National Bank, Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (1983), *reprinted in* [1983 - 1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,732; Interpretive Letter No. 367 (1986), *reprinted in* [1985 - 1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,537.

Part 9 contains provisions governing the treatment of funds awaiting investment or distribution, the investment of funds held as fiduciary, prohibitions against self-dealing, and compensation of bank fiduciaries. Part 9 requirements also apply to any investments made by a national bank trustee, including mutual fund investments, and prohibits self-dealing by fiduciaries. Bank trustees may not purchase proprietary or bank-advised mutual funds unless authorized by state law, trust instrument, court order, or consent, and only when appropriate for the account.

The OCC may take enforcement action against a national bank, its employees, or any institution-affiliated party[1] who violate the self-dealing or other relevant provisions of Part 9 when providing investment advice to customers. Although the OCC has not yet used Part 9 to bring a mutual fund-related formal enforcement action, the OCC has brought enforcement actions against national banks for improprieties in the administration of collective investment funds. For example, in 1989, the Comptroller revoked a national bank's trust powers when a trust officer purchased stock (in which the bank's president and a director had a conflicting interest) for the bank's common trust fund, in violation of the conflict of interest prohibition in 12 C.F.R. § 9.12. *In the Matter of Central National Bank of Mattoon*, AA-EC-87-83 (1989). The Comptroller also found that the bank violated 12 C.F.R. § 9.18 for its failure to value trust assets properly.

2. **Please provide a list, with an explanation of the alleged wrongdoing and the sanction applied, of OCC enforcement actions where sanctions have been applied against banks or their employees in connection with mutual fund sales. Provide similar information where OCC merely has required the violators to change their practice.**

As I stated during the March 3 hearing, the OCC has not initiated final, formal administrative action against national banks or national bank employees expressly in connection with mutual fund sales activities. The OCC, however, has undertaken significant steps to ensure that national bank mutual fund activities are conducted in accordance with applicable law and are protective of customer interests.

Where the OCC finds less significant compliance issues, we address them through examination criticisms, letters to bank boards, and other informal enforcement mechanisms. Where national banks fail to adequately respond to these criticisms, the OCC is committed to seeking all appropriate formal enforcement remedies. As stated in the our Securities Activities Enforcement Policy (Attachment A), the OCC believes that formal enforcement action is particularly appropriate to address cases involving customer abuse, fraud, and other deceptive or unfair practices in mutual fund or other securities sales. When pursuing formal enforcement actions, the OCC generally seeks remedies based on comparable SEC actions. *Id.*

Since January 1993, the OCC has reviewed the mutual fund activities of 250 community banks and approximately 75 bank holding companies, controlling 430 national banks. During

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[1]Under federal banking law, the term "institution-affiliated party" includes: 1) directors, officers, employees, controlling stockholders, or agents of an insured depository institution; 2) any other person who has filed a change in control notice; 3) shareholders, consultants, joint venture partners, or other persons who participate in conducting an insured depository institution's affairs; and 4) independent contractors, including attorneys and accountants. 12 U.S.C. § 1813(u).

the course of the review of the community banks, the OCC criticized some aspect of mutual fund activities in 34 banks. With respect to those 34 banks, the OCC criticized mutual fund practices in one or more of the following areas: (i) adequacy of disclosures and advertising - 25 banks; (ii) adequacy of mutual fund policies and procedures - 13 banks; (iii) adequacy of suitability management and documentation - 11 banks; (iv) program management - 10 banks; (v) oversight of third party vendors - 8 banks; (vi) adequacy of audit function - 6 banks; (vii) appropriateness of incentive compensation systems - 3 banks; and (viii) overall setting and circumstances - 3 banks. During the course of the review of the bank holding companies, the OCC criticized some aspect of mutual fund activities in 39 bank holding companies. With respect to those 39 companies, the OCC criticized mutual fund practices in one or more of the following areas: (i) adequacy of disclosures and advertising - 29 institutions; (ii) adequacy of mutual fund policies and procedures - 13 institutions; (iii) program management - 10 institutions; (iv) adequacy of suitability management and documentation - 9 institutions; (v) appropriateness of incentive compensation systems - 7 institutions; (vi) adequacy of audit function - 6 institutions; (vii) overall setting and circumstances - 5 institutions; and (ix) product selection - 5 institutions.

With respect to many of the criticisms noted above, corrective action was undertaken immediately; in the others, bank management committed to correct the deficiencies. In accordance with OCC policy, examiners will go on-site at each institution offering mutual funds within the present 12- or 18-month supervisory cycle, or sooner if warranted, to ensure that appropriate corrective action has been taken. In the event corrective action was not implemented, the OCC will seek all appropriate enforcement remedies.

3. **Please provide copies of customer complaints filed with the OCC last year involving mutual funds. Please advise us of the final disposition of these complaints. With respect to the complaints that resulted in restitution to customers, please describe the nature of the violation involved, and whether restitution was voluntarily offered, or required by the OCC.**

Pursuant to your request, we have attached copies of the customer complaints filed with the OCC involving mutual funds (Attachment B). A review of complaints filed with all OCC offices revealed that 18 complaints involving mutual funds were filed with the OCC from January 1, 1993 through the first quarter of 1994. Customer and bank names have been redacted from the attached copies.

As the attached copies will indicate, 2 of the 17 complaints are unresolved, 9 cases resulted in reimbursement to the customer, 3 cases failed to result in reimbursement, and 3 cases sought no reimbursement. The 8 cases that resulted in reimbursement involved customer/bank disputes in one or more of the following areas: (i) failure to disclose terms/risks of the investment - 5; (ii) suitability - 2; and (iii) unauthorized purchase - 1. In each complaint listed above, the OCC contacted the bank concerning the specific customer complaint. The restitution provided was voluntarily offered by the bank.

4. **In how many instances and involving what program areas or violations has the OCC made enforcement referrals to the SEC? What is OCC policy in this area?**

Since 1991, the OCC has made 24 referrals to the SEC for violations of the federal securities laws. The OCC made referrals in these instances for possible violations such as insider trading, violations of Rule 144, improper transfer agent activities, and inaccurate reporting of financial statements and other disclosure problems by bank holding companies. In that time, the OCC also has granted the SEC access to information collected and maintained by the OCC in 22 instances. The OCC's revised Securities Activities Enforcement Policy describes the OCC's policy of making appropriate referrals to the SEC and other regulatory agencies and cooperating with such agency's investigation and prosecution of securities law violations. Examining Issuance 252 (July 26, 1990) (Attachment C) details procedures for referring transfer agent violations to the SEC. When the OCC uncovers incidents of noncompliance with the federal securities laws that are not under its jurisdiction, the OCC refers such allegations to the SEC and cooperates with the SEC's investigation and prosecution.

5. **How many national banks have a suitability program? What do national bank suitability programs entail? How are national bank suitability programs examined and enforced? How do national bank suitability programs differ from the requirements of the NASD suitability rules?**

The vast majority of the sales of retail nondeposit investment products in banks occur in either bank subsidiaries, affiliated non-banks, or unaffiliated broker/dealers operating under agreement with the bank. Each of the above listed entities is required to be registered as a broker/dealer with the SEC and is subject directly to the NASD's Rules of Fair Practice. Sales of retail nondeposit investment products occurring directly in banks are subject to a supervisory scheme designed to achieve the same protections accorded by NASD rules. The OCC expects all national banks to adopt suitability programs at least as comprehensive as that required under the Rules of Fair Practice.

Under existing OCC policy, all national banks engaging in the sale of retail nondeposit investment products are expected to determine, consistent with the NASD Rules of Fair Practice ("NASD Rules"), whether each recommended investment product is an appropriate investment for the customer. The Interagency Statement on Retail Sales of Nondeposit Investment Products ("Interagency Statement") sets forth suitability standards that track the language of the NASD Rules (*see* Attachment D, which compares the language of the Interagency Statement and the NASD Rules). In addition, OCC examination procedures ("Examination Procedures") specifically reference the NASD standards as appropriate for national banks. *See* Comptroller's Handbook for National Bank Examiners § 413.1. Banks should ensure that any salespeople involved in the sale of retail nondeposit investment products obtain sufficient information from customers to enable the salesperson to make a judgment about the suitability of the recommendation for particular customers. As detailed in the Examination Procedures, "[a]t a minimum, suitability inquiries should be made consistent with the Rules of Fair Practice concerning the customer's financial and tax status,

investment objectives, and any other factors that may be relevant, prior to making recommendations to the customer." OCC policy requires that this information be documented and updated as necessary. The OCC views banks operating a retail securities business without appropriate suitability procedures to be engaging in an unsafe and unsound practice. As detailed in the response to question 6a, unsafe and unsound practices may constitute a violation of 12 U.S.C.§ 1818 potentially subjecting the bank to the full range of OCC enforcement remedies.

You have also inquired how national bank suitability programs are examined. During the present supervisory cycle, the OCC will be reviewing the activities of every national bank offering mutual fund products. A detailed review of bank suitability systems will be a principle focus of the OCC's review. As set forth expressly in OCC examination guidelines, examinations of national bank suitability programs should include, among other actions, a review of the systems the bank has in place to make suitability inquiries, suitability judgments, and periodic account reviews. Additionally, examiners should investigate marketing programs that target a class of customers, customer complaints, sales to first-time and risk adverse investors, sales made by high- or low-volume salespersons, volatile and new products, and the existence of mutual fund redemptions after relatively short testing periods.

An inquiry into the examination of suitability programs, by necessity, requires an analysis of not only applicable written regulations or policies, but also a review of personnel available to examine and enforce those written programs. As is more fully detailed in a memorandum attached under a separate cover to you this date, a comparison of personnel resources of the SEC with the OCC and other Federal banking agencies makes it clear that the bank regulators have far greater staff resources to police the operations of banks involved in mutual fund activities. The OCC has devoted considerable supervisory attention to bank involvement in mutual funds. As stated above, the OCC will examine the activities of every national bank offering mutual fund products during the present supervisory cycle.

6a. **How does 12 U.S.C. § 1818 authorize the OCC tô enforce the federal securities laws and the rules and regulations thereunder? How can violations of the federal securities laws by a bank, its securities subsidiary, or a third-party broker-dealer be considered "unsafe and unsound practices"? Has any court ever considered 12 U.S.C. § 1818 to reach violations of the federal securities laws and the rules and regulations thereunder?**

There are two ways that section 1818 authorizes the OCC to enforce the federal securities laws. First, section 1818 authorizes the imposition of cease-and-desist orders, removals, and civil money penalties for violations of any law, rule, or regulation, or any condition imposed in writing. The plain language of section 1818 permits the OCC to act to remedy violations of *any* law, rather than violations of only banking laws. Administrative enforcement decisions have upheld such an interpretation of section 1818's scope. *See, e.g., In the Matter of Robert J. Aulie, Brooklyn Savings Bank, Danielson, Connecticut*, Docket No. FDIC-91-189e. Second, the "unsafe or unsound practices" authority in section 1818 provides

another basis for bringing actions for violations of the federal securities laws. The legislative history to the Financial Institutions Supervisory Act of 1966 defined "unsafe or unsound practice" as "any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds." 112 Cong. Rec. 26474 (1966). Federal courts have consistently relied on this definition in determining what constitutes an unsafe or unsound banking practice. Improper conduct of securities activities exposes banks to significant litigation risk and could in fact constitute an unsafe and unsound banking practice. Therefore, conduct that violates the federal securities laws also may constitute an unsafe or unsound practice.

6b. Please submit a report on all actions taken by the OCC against banks or their employees for violations of the federal securities laws. How many actions has the OCC brought against banks in their capacity as municipal securities and government securities dealers; transfer agents; and for mutual fund or other securities sales? How does the OCC's investor protection enforcement program compare and contrast with the SEC's investor protection enforcement program?

We note that the efficacy of our enforcement program cannot be measured solely by the number of formal actions brought. Because of the OCC's ongoing examination presence in national banks, we can identify operational areas needing enhancement and criticize institutions for their regulatory shortcomings through reports of examinations. These steps often prevent more serious compliance problems. The OCC also relies on informal enforcement efforts, such as supervisory letters, to remedy successfully supervisory concerns. Although we often address supervisory concerns informally, the OCC is fully committed to bringing formal enforcement actions whenever appropriate. When a bank fails to comply with previous OCC directives or respond to examination criticisms, or engages in a serious violation of law or unsafe and unsound practice, formal enforcement actions are particularly appropriate to remedy improper practices or violations and impose proper penalties.

Since 1983, the OCC has brought 67 formal actions against national banks for violations of the federal securities laws (*see* Attachment E). This total does not include informal actions that the OCC often has taken to correct federal securities law violations that it uncovers through its supervision of national bank securities activities. The attached list represents our best efforts at full disclosure but we may have undercounted the number of actions brought.

The OCC has brought seven actions against national banks for municipal securities-related violations and 33 actions for government securities-related violations. The OCC has brought five actions for transfer agent-related violations. The other 34 actions found in our review of enforcement records include actions brought for violations of anti-fraud, reporting, proxy, tying, and beneficial ownership provisions of the federal securities laws.

You have also requested that we comment on the OCC's authority to bring enforcement

actions, with reference to a table describing the SEC's administrative sanctions and persons subject to them. We believe that the OCC authority to address violations of law under our jurisdiction, pursuant to both the federal securities laws and federal banking laws, is at least comparable to that of the SEC. The OCC is empowered to bring the same actions under the federal securities laws as the SEC in many circumstances, e.g. municipal securities dealers, government securities brokers and dealers, transfer agents, and national banks subject to Section 12(i) of the 1934 Act. The OCC is also empowered pursuant to 12 U.S.C. § 1818 to sanction violations of any securities laws, such as the anti-fraud provisions, applicable to institutions and individuals under our jurisdiction. The OCC additionally uses Section 1818 to enforce banking regulations governing securities activities of banks, including 12 C.F.R. Parts 9 and 12.

Finally, the OCC possesses plenary authority under Section 1818 to sanction any unsafe or unsound banking activity, including securities activities, by institutions and individuals subject to our jurisdiction. This exceptionally broad grant of authority does not have a parallel under federal securities laws. With respect to the sanctions referenced for self-regulatory organizations in the SEC's table, it should be noted that the OCC does not rely on industry associations to enforce banking laws and regulations. Through our staff of nearly 3,000 bank examiners, we take direct responsibility for supervision of bank activities, including securities activities, and directly sanction improper conduct.

The sanctions available to the OCC under Section 1818 include cease and desist orders, orders of restitution, civil money penalties, and removals and suspensions of individuals. The Securities Enforcement Remedies and Penny Stock Enforcement Act of 1990 ("1990 Act") reinforced the SEC's enforcement ability by providing the SEC with remedies for violations of federal securities laws that were modelled after the sanctions long available to federal banking regulators under Section 1818. The legislative history of the 1990 Act notes that the new authority granted to the SEC was based on powers that were already available to the federal banking agencies. H.R. Rep. No. 101-616, 101st Cong., 2d Sess., 15-16, 23 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1382-83, 1390.

6c. **What rules does the OCC have with regard to the rights of aggrieved individuals in connection with bank securities activities? Is it the OCC's position that the National Bank Act preempts the application of the federal securities laws? What is the OCC's view on *Simpson v. Mellon Bank* (E.D. Pa. 1993)?**

There are a number of ways for aggrieved individuals to seek redress for any injury resulting from securities activities at national banks or their subsidiaries or affiliates: arbitration, private rights of action, and complaints to the OCC. Many registered subsidiaries or affiliates provide an arbitration clause in their standard investment account contracts. Banks that directly sell securities also may enter into arbitration agreements with customers.

Bank customers also may institute litigation alleging a violation of the anti-fraud provisions of the federal securities laws. Courts have long recognized an implied private right of action

under these provisions. *See, e.g., Fischman v. Raytheon Manufacturing Co.*, 188 F.2d 783 (2d Cir. 1951); *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128 (1972); *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). Noncompliance with the Interagency Statement (February 15, 1994) may, in certain cases, also constitute fraudulent conduct. For example, if a national bank employee represented that a customer's investment in a mutual fund was FDIC-insured, this misrepresentation would contravene both the Interagency Statement and the anti-fraud provisions of the Exchange Act. Investment company shareholders also may bring a private action alleging violations of the Investment Company Act of 1940.

For banks that offer nondeposit investment products through registered subsidiaries or affiliates, aggrieved customers also can bring grievances to the NASD or the Municipal Securities Rulemaking Board. Aggrieved customers also may complain to the OCC about a bank's securities sales practices. The OCC investigates such complaints and, in instances where it finds that the complaint is meritorious, can order reimbursement, restitution, or other appropriate remedies.

You also asked whether it is the OCC's position that the National Bank Act preempts the federal securities laws. The OCC does not believe that the National Bank Act preempts the federal securities laws. In fact, the OCC's Securities Activities Enforcement Policy makes clear that the OCC generally will seek penalties similar to those imposed on non-bank entities for violations of the federal securities laws. The OCC often has brought actions against national banks for violations of these laws.

The *Simpson v. Mellon Bank* decision addressed whether bank products offered to fiduciary customers are subject to regulation under the federal securities laws. In defining securities, courts have considered a number of factors, including whether a comprehensive regulatory scheme exists for such products, rendering unnecessary the application of the federal securities laws. *See Reves v. Ernst & Young*, 494 U.S. 56 (1990). For example, courts have held that certificates of deposit issued by federally regulated banks which are subject to a comprehensive set of regulations are not securities subject to the federal securities laws. *Marine Bank v. Weaver*, 455 U.S. 551 (1982). Collective investment funds similarly are subject to a comprehensive system of regulation under 12 U.S.C. § 92a, 12 C.F.R. Part 9, and other federal banking laws. Because federal banking law generally provides the necessary framework for regulation of most collective investment fund activities, the *Simpson* court refused to subject such funds to regulation under the federal securities laws.

6d. Does the OCC make its enforcement actions public? How can a potential customer find out if there is a pattern of examiner requests that a particular bank or its employees "change their practices" in this area?

The OCC publishes a list of formal enforcement actions (such as cease and desist orders and civil money penalties) it has taken in its monthly publication, *Interpretations and Actions*. The OCC discloses the nature of the enforcement action, the bank and/or individuals involved, and the date of the action. The OCC's Communications Division makes available

copies of decisions or settlement documents. The OCC also issues press releases on significant enforcement actions.

Individuals researching any OCC securities-related actions may write or telephone us for information. The OCC also refers public inquiries concerning securities industry professionals to the NASD. The OCC does not disclose to potential bank customers whether an individual examiner has requested that a bank or its employees "change their practices". Because individual examiner judgments and communications are dynamic and often informal, these communications generally are not disclosed to the public. However, significant problems resulting in formal enforcement actions would be publicly disclosed as discussed above. The OCC's practices concerning the disclosure of examination material are substantially the same as those of other regulatory bodies, including the NASD.

7. **What progress are the OCC and SEC making in coordinating their examination and enforcement programs? Are there any joint enforcement efforts currently pending between the SEC and the OCC? Please submit a list of the dates, participants, and summaries of any and all interagency meetings on examination and enforcement issues.**

The OCC and the SEC have coordinated examination and enforcement programs in many respects.

In 1990, the SEC formed two task forces to focus on compliance with federal securities laws by financial institution holding companies that operate under the SEC's jurisdiction. The OCC assisted the SEC's task forces in reviewing the adequacy and accuracy of Exchange Act and Securities Act disclosures filed with the SEC by registered financial institution holding companies. The OCC also provided examination and other information to support SEC investigations and enforcement efforts. The OCC also issued a banking circular, BC-245 (Attachment F), to inform national banks of the work of these task forces and OCC efforts to assist them.

The SEC and the OCC have conducted joint transfer agent examinations for a number of years, and have cooperated in examining investment advisers, as well. The OCC also has invited the SEC more broadly to conduct joint examinations of entities subject to both agencies' oversight. We currently are developing guidelines for such examinations.

In addition, the OCC and the SEC have brought various joint enforcement actions. One example of this cooperation was the 1992 Government Securities Dealers case, where the OCC, the FRB, and the SEC jointly brought actions against 98 government securities brokers and dealers for failure to file required reports of lost or stolen securities as mandated by the Government Securities Act. The OCC and the SEC currently are jointly pursuing several enforcement actions involving securities law violations. As noted above, the OCC also routinely makes enforcement referrals to the SEC when it discovers possible violations of the federal securities laws that fall under SEC jurisdiction.

SEC representatives are participants in the Bank Fraud Working Group, a group of bank regulatory and other governmental agencies that meets on a monthly basis to coordinate regulatory and enforcement efforts against bank fraud, and discusses how to improve agency coordination and cooperation.

Per your request, please find a list of meetings held between OCC and SEC representatives on enforcement and regulatory issues. The list is limited to meetings conducted since I became Comptroller of the Currency in April, 1993, and represents our best effort to reconstruct all such meetings. The list may not be all-inclusive and does not include telephone calls.

- March 17, 1994: Edward Dumas and Mike Brosnan (OCC) participated in meeting of the Working Group on Financial Markets (members include Treasury, SEC, FRB, CFTC; OCC is not a member) to discuss bank internal risk controls.

- March 16, 1994: William P. Bowden, Jr., Robert B. Serino, and Ellen Broadman (OCC), met with Joseph Goldstein (SEC) to discuss making OCC examiners available to testify in an action being brought by the SEC.

- March 15, 1994: Meeting between Julie Olson, Joe Malott, and Donald Lamson (OCC) and SEC representatives, to discuss government securities recordkeeping.

- March 14, 1994: Edward Dumas and Karen Epps (OCC) participated in meeting of the Working Group on Financial Markets to deliver presentation on derivatives-related disclosures by the Federal Accounting Standards Board.

- March 14, 1994: Ralph Sharpe and John Shockey (OCC) met with Tom Hammill and Joseph Goldstein (SEC) to discuss coordination of alerts on improper activities by off-shore banks. The two agencies agreed to continue to exchange information, as appropriate.

- March 9, 1994: Doug Harris and Karen Epps (OCC) participated in meeting of the Working Group on Financial Markets to discuss derivatives-related accounting issues.

- March 9, 1994: Owen Carney and David Nebhut (OCC) observed a focus group assessing mutual fund disclosures in Baltimore, MD, with SEC staff.

- March 4, 1994: Doug Harris and Ellen Broadman (OCC) participated in meeting of the Working Group on Financial Markets to discuss multilateral netting issues.

- February 28, 1994: Doug Harris, Edward Dumas, and Mark Winer (OCC) participated in meeting of the Working Group on Financial Markets to discuss activities of the Interagency Task Force on Bank-Related Derivatives Activities (members include OCC, FRB, FDIC, OTS).

- February 25, 1994: Doug Harris (OCC) participated in meeting of the Working Group on Financial Markets to discuss derivatives-related issues.

- February 22, 1994: Ellen Broadman, William Dehnke, and Rachel Romyn (OCC) met with Barry Barbash and other SEC representatives, and OTS and FRB representatives, to discuss mutual fund disclosure and examination issues.

- February 17, 1994: Rachel Romyn and David Nebhut (OCC) met with Susan Woodward and staff (SEC) to discuss the objectives of a broad mutual funds survey.

- February 3, 1994: Donald Lamson (OCC) and C. Parrish and P. Gerlach (SEC) met to review SEC case against national bank. OCC requested copies of documentation.

- February 3, 1994: Donald Lamson (OCC), L. Lee, T. Lawson, Joseph Goldstein (SEC), and bank attorneys met to discuss possible consensual resolution to enforcement action.

- February 2, 1994: Donald Lamson (OCC) and Judy Gelber (SEC) met to provide SEC staff access to information supporting a prior OCC referral involving possible illegal insider trading. The OCC provided the SEC with hard copies of supporting data on February 7, 1994.

- February 2, 1994: David Apgar and David Nebhut (OCC) met with Susan Woodward of the SEC to discuss surveying bank customers directly about mutual fund issues.

- January 26, 1994: David Nebhut (OCC) met with SEC staff to discuss results of Richmond focus group.

- January 18, 1994: Meeting between Susan Woodward of the SEC, several members of her staff, a representative from the Federal Trade Commission, representatives from an outside consulting staff, David Apgar, Beth Kirby, Owen Carney, Julie Olson, William Dehnke, and Pat Eggleston (OCC), to discuss the results of focus group meetings held jointly by the OCC and the SEC. There was discussion about how to design a joint OCC/SEC survey, how to address customer complaints about investments purchased through banks, and registered broker-dealers working in banks.

- January 11, 1994: Donald Lamson and Sharon Gilstrap (OCC), L. Lee, M. Mashburn (SEC), and bank representatives met to discuss possible consensual resolution to an enforcement action.

- January 11, 1994: William Dehnke, Suzette Greco, Keith Larkin (OCC), Gene Gohlke, and Richard Jackson (SEC) met to discuss examinations of mutual funds, including examinations of the Dreyfus Corporation.

- January 6, 1994: David Apgar, Owen Carney, and William Dehnke (OCC) attended a mutual funds focus group meeting in Richmond, VA, with Barry Barbash and Susan Woodward (SEC).

- January 4, 1994: William P. Bowden, Jr., and Ellen Broadman (OCC), met with Barry Barbash, Tom Harmon, and Barbara Green of the SEC to discuss mutual fund-related issues.

- December 20, 1993: William P. Bowden, Jr., Stephen R. Steinbrink, David Apgar, and I (OCC) met with Arthur Levitt, Chairman, SEC, to discuss sales of mutual funds at national banks.

- December 13, 1993: David Apgar, William Dehnke, and David Nebhut (OCC) met with SEC, FRB, and FTC staff to discuss results of first SEC mutual fund survey, the possibility of a joint survey, and plans for focus groups.

- November 29, 1993: T. Lawson, L. Lee, M. Mashburn (SEC), Donald Lamson, Carolyn Amundson (OCC), and two bank attorneys met to discuss possible settlement terms to an administrative enforcement action.

- November 23, 1993: Meeting between William P. Bowden, Jr. (OCC) and Simon Lorne (SEC), to discuss issues of interest to the two agencies.

- November 18, 1993: Ellen Broadman, William Dehnke, Suzette Greco (OCC), Cliff Kirsch, and Wendall Faria (SEC) met to discuss SEC regulation of variable annuities.

- November 5, 1993: Stephen Steinbrink, William P. Bowden, Jr., and I (OCC), met with Arthur Levitt, Chairman, SEC, to discuss coordination between the two agencies.

- October 13, 1993: Jimmy Barton and Merrill Hendricks (OCC) met with SEC officials to discuss an OCC enforcement case.

- August 13, 1993: I met with Arthur Levitt, Chairman, SEC, to discuss coordination between the two agencies.

8. What are the OCC's rules against frontrunning?

Although there is no specific regulation defining or prohibiting frontrunning under the federal securities laws, the practice is generally prohibited by the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 when insider trading or fraud is involved. As such, both the SEC and the federal bank regulatory agencies, including the OCC, could bring enforcement actions when frontrunning involves such practices.

Frontrunning also may violate federal banking laws where, for example, the practice involves a breach of fiduciary duty. The OCC also could bring an action under 12 U.S.C. § 1818 to remedy such violations or if it determined that frontrunning constituted an unsafe and unsound practice.

OCC regulations address certain aspects of frontrunning. For example, OCC regulations require bank officers and employees who make investment recommendations or decisions for the account of customers, participate in the determination of such recommendations, or obtain information concerning securities purchases and sales, to report transactions exceeding $10,000 in securities made by them or on their behalf, every calendar quarter. 12 C.F.R. § 12.6(d). If the OCC discovered discrepancies between the trades reported and those actually made, the OCC could bring an action for improper reporting of securities transactions under Part 12. In addition, through review of these records, the OCC could identify frontrunning that violated federal banking or securities laws.

Furthermore, a bank's activities as investment adviser to an investment company are subject to anti-fraud provisions and disclosure requirements in the Investment Company Act. Rule 17j-1 makes it unlawful for mutual fund investment advisers to engage in a fraud or deceit perpetrated upon the investment company or to engage in any manipulative practice. Rule 17j-1(c) also includes a quarterly disclosure requirement for all investment advisers, requiring them to disclose dates, titles, number of shares, and principal amount of securities transactions, the price at which the transaction was effected, and whether the transaction involved a purchase, sale, or other type of acquisition or disposition. Those disclosures enable the investment company and regulators to identify improper personal trading by investment advisers that may constitute a manipulative, fraudulent, or deceptive practice. The OCC has asked the SEC to coordinate efforts to address frontrunning by investment advisers.

I hope this information is useful to you. If you have any further questions, please contact me at (202) 874-4900 or David Apgar, Senior Policy Advisor, at (202) 874-4890.

Very truly yours,

Eugene A. Ludwig

Eugene A. Ludwig
Comptroller of the Currency

Attachment A

POLICIES & PROCEDURES MANUAL

Comptroller of the Currency
Administrator of National Banks

Section: Bank Supervision

Subject: Securities Activities Enforcement Policy

TO: Deputy Comptrollers, District Administrators, Department and Division Heads, District Counsel, and all Examining Personnel.

I. PURPOSE

This issuance discusses the OCC's use of administrative enforcement authority in federal securities enforcement actions. It replaces PPM 5310-5, dated October 6, 1988. This policy is designed to provide firm, prompt, and fair action on matters involving use of OCC enforcement authority. The policy serves the additional function of ensuring protection of the investing public, compliance with applicable laws, and the safety and soundness of the national banking system. The OCC's securities activities enforcement policy is separate from the agency's general enforcement policy contained at PPM 5310-3.

This policy and these procedures are internal guidelines for the use of the OCC and do not create any substantive or procedural rights enforceable at law or in any administrative proceeding, or affect the authority of other governmental agencies.

II. POLICY AND SCOPE

A. AUTHORITY

The OCC uses a number of tools to carry out its obligations to enforce the federal securities laws as they apply to national banks and individuals who are subject to the jurisdiction of the OCC. The OCC has the power to institute enforcement proceedings under the federal securities laws and 12 U.S.C. 1818 for violations of federal securities laws. The OCC may bring actions for violations of the Securities Exchange Act of 1934 (Exchange Act) registration, reporting and disclosure provisions, and provisions governing (i) national bank municipal securities dealers, (ii) national bank government securities brokers and dealers, and (iii) national bank transfer agents. Actions may also be based on violations of 12 C.F.R. Part 16, the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Trust Indenture Act of 1939, and other laws regulating the securities activities of national banks. In cases where a violation of the federal securities laws also

adversely affects a national bank's capital level, the OCC retains the right to institute Prompt Corrective Action (PCA) proceedings pursuant to its regulatory authority.

B. POLICY

The OCC's securities enforcement policy is designed to serve the following purposes, as appropriate: 1) to be preventive; 2) to be remedial/corrective; 3) to be disciplinary; and 4) to be a deterrent. These purposes are often related and are not meant to be mutually exclusive. The OCC uses a range of enforcement remedies, including civil money penalties, cease and desist orders, injunctions, censures, suspensions, bars, removals, limitations, and a variety of other remedies depending on the nature of the violation. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, 15 U.S.C. 78u-2 and 78u-3 (Securities Remedies Act), provided to the OCC new remedies for certain federal securities laws violations, including both civil money penalties and cease and desist orders. These remedies supplement existing remedies available to the OCC under the securities and banking laws.

The OCC will respond promptly and firmly to actual or potential problems or violations of law in an individual bank or group of banks, or committed by persons associated with the institution (associated person) or an institution affiliated party or parties. (An "associated person" is not necessarily the same as an "institution-affiliated party," although some overlap may exist. An "institution-affiliated party" generally encompasses a wider range of individuals.)

The OCC enforces the federal securities laws as they relate to the securities activities of national banks in a manner generally consistent with the discipline and treatment accorded similarly situated nonbank entities and their associated persons. The OCC consults, as appropriate, with other securities regulators (such as the Securities and Exchange Commission and state securities regulatory authorities), as well as self-regulatory organizations (such as the National Association of Securities Dealers) in instances in which administrative enforcement action is being considered. Consultation concerning the appropriateness of

bringing an action and the severity of proposed sanctions is consistent with the principle of comparable regulation under the federal securities laws, and is intended to ensure that remedies sought by the OCC generally are consistent with those required by other securities regulators in like circumstances, unless alternate remedies are more appropriate. The OCC may pursue enforcement actions available under federal banking laws for securities law violations, when such actions provide a more effective or efficient enforcement vehicle.

C. FORMAL ENFORCEMENT ACTIONS

The OCC will use formal securities enforcement actions in cases involving:

1. violations of the antifraud provisions of the federal securities laws, or rules promulgated thereunder;

2. misuse of customer funds or securities;

3. customer abuse;

4. other deceptive or unfair practices;

5. serious and/or repetitive violations of law;

6. significant internal controls breakdowns; or

7. the existence of a likelihood of future violations if formal enforcement action is not taken.

Formal enforcement actions also may be instituted to address other situations involving violations of the federal securities laws, including situations that result in prompt corrective action.

The OCC has the discretion to seek remedies for securities law violations under either the federal securities laws or national banking law, e.g., 12 U.S.C. 1818, depending on the circumstances of a particular case. The OCC recognizes the desirability of equality of securities law enforcement among securities regulators, but also remains mindful that, in certain circumstances, banking

law may provide the most efficient and effective means to address securities law violations.

D. PROMPT CORRECTIVE ACTION

The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, requires federal financial institution regulators to implement and enforce procedures for financial institutions to maintain minimum capital levels. National banks that do not meet such capital levels are subject to restrictions on the activities in which they may engage and other limitations. The OCC issued regulations discussing the new capital categories and procedures pertaining to PCA in 1992. See 57 Fed. Reg. 44,866 et seq. (1992), codified at 12 C.F.R. Parts 6 and 19.

In considering appropriate prompt corrective actions, the OCC may consider securities violations, including those involving unsafe or unsound banking practices or affecting capital levels.

E. MITIGATIVE FACTORS

In some instances, the OCC may wish to modify a formal enforcement action in view of the presence or absence of one or more mitigative factors. In such instances, the agency may decide to make a modified charge (or charges) or seek a lesser sanction. Among the mitigative factors to be considered are:

1. The capability, willingness, cooperation, integrity, commitment and intent of bank management, the board of directors, and/or ownership to correct the problems. The OCC will consider the extent to which meaningful corrective action has already been taken, is being taken (including, where appropriate, restitution to customers), or can reasonably be expected to be taken.

2. The absence of fraud, scienter, recklessness, or deliberate deception of the public. (The Supreme Court has in certain cases defined "scienter" as "a mental state embracing intent to deceive, manipulate or defraud." Certain courts of appeals have concluded that scienter includes recklessness.)

POLICIES & PROCEDURES MANUAL

Comptroller of the Currency
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Section: Bank Supervision

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3. The gravity or extent of violations.

4. Whether, and how much, the public was exposed to risk.

5. The bank's previous compliance record and response to previous criticisms or supervisory records. In the case of an individual, a respondent's previous record and response to previous criticisms.

6. The presence of unique circumstances that might justify lesser sanctions.

The presence of any of these factors would not *per se* constitute a defense against any enforcement action or warrant the imposition of milder sanctions. Nor does the consideration of any of the above factors lessen the OCC's intention to pursue a vigorous securities enforcement policy to safeguard the investing public. Rather, every case shall be evaluated on its own merits before a decision is made to institute enforcement action, make a modified charge (or charges), or seek a modified sanction.

The OCC also takes mitigative factors into account in determining the amount of civil money penalty that should be assessed. Civil money penalties assessed for violations of the Exchange Act generally will be determined under the applicable categories provided in the Exchange Act, using as a guide actions taken by the SEC in comparable circumstances.

III. PUBLIC DISCLOSURE OF ENFORCEMENT ACTIONS

In order to give effect to the principle of competitive equality and in light of the practice of other agencies charged with enforcing the federal securities laws, administrative enforcement actions initiated in accordance with this issuance should be made public at their inception, unless the Comptroller, in his or her discretion, determines it is in the public interest that such proceeding be private. Thus, a Notice of Charges or a Notice of Assessment of Civil Money Penalty is public as of its filing. The result of this policy is that a federal securities enforcement action becomes public sooner than other types of OCC enforcement actions, which typically are made public just prior to hearing.

Similarly, pursuant to section 2547 of the Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789, 4886-88 (1990), 12 U.S.C. 1818(u), hearings on the record with respect to a notice of charges issued by the OCC in a banking enforcement action pursuant to 12 U.S.C. 1818 shall be open to the public, unless the Comptroller, in his or her discretion, determines that holding an open hearing would be contrary to the public interest. In addition, pursuant to section 913 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. 1818(u), the OCC shall publicize and make available to the public any final order issued with respect to any administrative enforcement proceeding initiated by such agency under this section or any other provision of law.

The OCC is legally required to publicly disclose all final cease and desist orders, civil money penalty orders, any final orders issued after an enforcement hearing process, as well as any modification and/or termination of such orders, formal agreements, and any condition imposed in writing. Under certain limited circumstances, mandatory disclosure may be delayed for a reasonable period of time. Decisions to delay publication are nondelegated and will be made by the Comptroller or his or her designee after review by the Washington Supervisory Review Committee.

Once a month, the OCC's Communications Division will publish a list of enforcement actions that includes the name of the individual or bank involved, the type of action, the date of the action, and whether the action was by consent. The Communications Division will maintain a file of all final formal enforcement actions and will provide copies of these documents upon request.

Nothing contained above is intended to relieve a national bank of its independent obligations to make required disclosures under the various securities laws and related regulations.

IV. PROCEDURES

OCC staff who believe that they have uncovered incidents of noncompliance with the federal securities laws should make a referral setting forth the alleged incidents to the Securities,

Investments, and Fiduciary Practices Division (SIFP), along with appropriate documentation.

A. CONTENTS OF ENFORCEMENT ACTIONS

Enforcement actions should address substantive supervisory or compliance problems. Enforcement actions need not address every supervisory or compliance issue identified. However, all documents should contain clear statements regarding any prohibited or restricted activities, remedial measures to be taken, and the time in which the bank, its board of directors, or management must act. The document should clearly state what action is expected of those parties subject to the terms of the document.

B. SUPPORT FOR DECISION

Decisions about whether to proceed with an enforcement action, and about the nature and severity of the action should be fully supported in decision memorandums by the agency's enforcement staff or designee and made a part of the bank's permanent file.

C. REFERRALS

The OCC makes referrals as appropriate to the SEC and other regulatory agencies and cooperates with such agency's investigation and prosecution. The OCC will also provide the SEC or other regulatory agency with access to relevant information collected and maintained by the OCC in appropriate situations, provided that such agency agrees to maintain appropriate confidentiality with regard to any relevant OCC information.

Similarly, the OCC receives referrals from the SEC and other federal authorities of possible violations of the federal securities laws that fall under the OCC's jurisdiction. In the event of such a referral, the OCC shall take all necessary steps to maintain appropriate confidentiality with regard to the information forwarded.

D. TERMINATION OF ENFORCEMENT ACTIONS

1. 12 U.S.C. 1818

The OCC may terminate or modify an enforcement action brought under 12 U.S.C. 1818 whenever, in the judgment of the agency's enforcement staff, such action is consistent with the supervisory goals for the bank and the OCC. Such actions must be supported by substantial and sustained compliance with the action in place. The responsible office will fully support a decision to terminate or modify an enforcement action by decision memorandums made a part of the bank's permanent file.

2. Federal Securities Laws

Administrative enforcement actions brought under authority of the federal securities laws result either in sanctions that are self-executing, such as censures, or of a limited duration, such as suspensions for periods of less than one year, or that are ongoing in nature. Examples of ongoing sanctions include bars, the imposition of continuing obligations to institute affirmative remedial or corrective measures, or obligations to refrain from certain activities. Termination of actions taken under authority of the federal securities laws resulting in self-executing sanctions is not appropriate. However, in cases resulting in ongoing sanctions or limitations of activities, the OCC may provide relief from certain continuing obligations (e.g., by granting permission to re-enter the securities business, with certain conditions, to persons previously barred). The OCC will consider such requests on a case-by-case basis, in light of all relevant circumstances. See 17 C.F.R. § 201.29; Securities Exchange Act Release No. 11267 (February 26, 1975), 6 SEC Docket 346.

V. RESPONSIBILITIES

Each party or individual charged with responsibility under this policy shall ensure that appropriate procedures are established to ensure that the OCC's enforcement policies are applied promptly, fairly, and consistently.

PPM-5310-5 (Rev.)

POLICIES & PROCEDURES MANUAL

Comptroller of the Currency
Administrator of National Banks

Section: Bank Supervision

Subject: Securities Activities Enforcement Policy

The Senior Deputy Comptroller for Bank Supervision Operations has the primary responsibility to use the OCC's administrative authorities as necessary to accomplish supervisory objectives. He or she retains for all national banks the authority to initiate, negotiate, execute, modify, or terminate enforcement actions undertaken to enforce the securities laws whether or not the bank is otherwise delegated.

The Securities, Investments, and Fiduciary Practices Division is responsible for handling securities enforcement actions against delegated and nondelegated banks.

The Senior Deputy Comptroller for Bank Supervision Operations shall use the Supervisory Review Committee to advise him or her on all enforcement actions involving bank securities activities. The Director of the Securities, Investments, and Fiduciary Practices Division shall be a member of the Supervisory Review Committee for purposes of voting on securities enforcement actions.

Stephen R. Steinbrink
Senior Deputy Comptroller for
Bank Supervision Operations

Attachment C

E C. 252

EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Examining Circular

Subject: Transfer Agent Referrals to SEC

TO: Deputy Comptrollers, Department and Division Heads, and All Examining Personnel

PURPOSE

This examining circular establishes procedures for processing transfer agent referrals to the Securities and Exchange Commission (SEC).

In accordance with an understanding reached in 1979, and pursuant to Section 17(c)(3) of the Securities Exchange Act of 1934, the OCC has agreed to report to the SEC significant violations of SEC transfer agent regulations or related adverse conditions disclosed by our supervisory process.

Presently, the Compliance Management Department processes transfer agent referrals based upon Fiduciary Data Sheet (FIDS) and ROSA information. However, under current supervisory procedures, such sources may not contain sufficient information to make an appropriate determination for referral.

PROCEDURES

Detailed information must be available for the OCC to determine whether an item falls within the understanding with the SEC, and for the SEC to determine whether it wants to investigate the activity. Therefore, when examiners discover violations of 17 CFR 240.17Ad 1-14 and/or 17 CFR 240.17f-2 during the supervisory process, they should include the following information in the Analysis section comment of SMS:

- Issuer name and account number;
- Citation of the regulation violated;
- Narrative description of the activity which resulted in a violation of transfer agent regulations; and
- Corrective action requested.

Date: July 26, 1990

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EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Examining Circular

Subject: Transfer Agent Referrals to SEC

A notification of the referral information in SMS should be sent to the Director for Compliance Programs. This notification and the information contained in the Analysis comment of SMS will be reviewed by the Securities & Corporate Practices Division and Compliance Programs Division prior to referral to the SEC. Supervisory offices will receive notification of such referrals and any subsequent OCC enforcement action.

ORIGINATING OFFICE

Any questions concerning this circular may be directed to the Director, Complaince Programs at 202-447-1731.

Ron Lindhart
Deputy Comptroller
for Compliance Management

Attachment D

SIDE BY SIDE, WORD FOR WORD COMPARISON OF INTERAGENCY AND NASD SUITABILITY STANDARDS

INTERAGENCY STATEMENT	RULES OF FAIR PRACTICE
Depository institution personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if depository institution personnel recommend nondeposit investment products to customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically.	(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (i) the customer's financial status; (ii) the customer's tax status; (iii) the customer's investment objectives; and (iv) such other information used or considered to be reasonable and by such member or registered representative in making recommendations to the customer.

Attachment E

The OCC has taken a number of formal and informal enforcement actions to redress violations of law relating to the securities activities of national banks. This appendix contains summaries of formal enforcement actions the OCC has taken since 1983 in each of the several major areas of bank securities activities for which it has enforcement authority.

Exchange Act Section 12(i)

1. OCC v. Torrance National Bank, Torrance, California, et al., C.A. No. 87-0884, U.S.D.C. D.C. (1987), involved a complaint for permanent injunctive relief, to which the defendant bank and individual defendants, all bank directors, consented, without admitting or denying any of the allegations in the complaint. The complaint contained allegations that the bank violated the reporting requirements of section 13 of the Exchange Act by failing to file in a timely manner required quarterly and annual reports. The complaint also contained allegations that several directors individually violated the beneficial ownership reporting requirements of sections 13 and 16 of the Exchange Act by failing to file required reports of beneficial ownership. The final order enjoined the bank and the directors from further Exchange Act violations and required the directors to file required beneficial ownership reports.

2. OCC v. T. Bertram Lance and Calhoun First National Bank, C.A. No. C86-19R, U.S.D.C. D.Ga. (1986) involved a complaint for permanent injunctive relief for violations of sections 13(a) and 14(a) of the Exchange Act. The complaint alleged that the defendants failed to disclose (1) check kiting, nominee loans, credit life insurance rebates, and other transactions that benefitted Lance, often to the detriment of the bank, and (2) loan participations from other banks that were recommended or directed by Lance at a time when he had had a material indirect interest in maintaining substantial personal borrowing relationships with the banks selling those participations. The bank consented to the entry of a permanent injunction, without admitting or denying the allegations of the complaint, and agreed to amend its securities filings to disclose all information on the above transactions required to be disclosed under the federal securities laws. Lance also consented, without admitting or denying the allegations of the complaint, to entry of a permanent injunction and agreed to provide the bank with all information on the above transactions necessary to make the required disclosures.

3. Comptroller of the Currency v. Farmers National Bank of Appomattox, Appomattox, Virginia, C.A. No. 86-1708, U.S.D.C. D.C. (1986), involved a complaint for permanent injunctive relief, to which the bank consented without admitting or denying any of the allegations in the complaint. The complaint contained allegations that the bank violated sections 12, 13, and 14 of the Exchange Act by (1) distributing proxy materials to shareholders without filing these materials with the OCC before distribution, (2) distributing proxy materials that contained information that was false or misleading, (3) failing to file any of its quarterly or annual reports on time since the bank first registered its securities, and (4) filing quarterly or annual reports that contained insufficient or misleading information. Finally the OCC alleged that the bank failed to file its registration statement with the OCC until 11 years after its securities were

required to be registered. The final order of permanent injunction enjoined the bank from further violations of these provisions of the securities laws and OCC implementing regulations, required the bank to rehold its 1986 annual meeting and required the bank to file amendments to various annual and quarterly reports.

4. OCC v. New World National Bank, Pittsburgh, Pennsylvania, C.A. No. 86-2047, U.S.D.C. D.C. (1986), involved a complaint for permanent injunctive relief, to which the bank consented without admitting or denying any of the allegations in the complaint. The complaint contained allegations that the bank violated section 13 of the Exchange Act by failing to file on a timely basis required annual and quarterly periodic reports of the bank's condition. Further, the complaint alleged that the reports, as filed, contained material misstatements of material fact. The final order of permanent injunction enjoined the bank from further violations of section 13 and OCC implementing regulations and required the bank to file amendments to various annual and quarterly reports.

5. Comptroller of the Currency v. Industrial National Bank of East Chicago, East Chicago, Indiana, C.A. No. 86-0310, U.S.D.C. D.C. (1986), involved a complaint for permanent injunctive relief, to which the bank consented without admitting or denying any of the allegations contained in the complaint. The complaint contained allegations that the bank violated sections 13 and 14 of the Exchange Act by (1) distributing proxy materials to shareholders without filing these materials with the OCC before distribution, (2) distributing proxy materials that contained information that was false or misleading, (3) failing to file any of its quarterly or annual reports in a timely manner and, (4) in some instances, failing entirely to file required periodic reports. The final order of permanent injunction enjoined the bank from further violations of these provisions of the securities laws and OCC implementing regulations, and required the bank to solicit proxies and file the required periodic reports in accordance with the requirements of the federal securities laws and regulations.

6. OCC v. Commonwealth National Bank, Mobile, Alabama, C.A. No. 85-0899, U.S.D.C. D.C. (1985), involved a complaint for permanent injunctive relief, to which the bank consented without admitting or denying any of the allegations in the complaint. The complaint contained allegations that the bank violated section 13 of the Exchange Act by failing to file on a timely basis required quarterly periodic reports of the bank's condition. The final order of permanent injunction enjoined the bank from further violations of section 13 and OCC implementing regulations.

7. Comptroller of the Currency v. Central National Bank, Canajoharie, New York, C.A. No. 85-3177, U.S.D.C. D.C. (1985), involved a complaint for a permanent injunction against the bank and a number of individual bank directors for violations of the beneficial ownership and periodic reporting and proxy solicitation requirements of the Securities Exchange Act of 1934. The bank and the individuals consented to entry of an order of permanent injunction without admitting or denying the allegations of the complaint, prohibiting them from further violations of sections 13 and 14 of the Exchange Act and requiring the reholding of a contested election for directors.

8. Selby v. Huron National Bank, Rogers City, Michigan, C.A. No. 85-2686, U.S.D.C. D.C. (1985), involved a complaint for a permanent injunction against the bank for violations of sections 13 and 14 of the Exchange Act, to which the bank consented without admitting or denying the underlying allegations. The OCC in its complaint alleged that the bank failed to file timely, accurate or complete annual and quarterly reports and proxy materials for distribution to shareholders. The final order of permanent injunction enjoined the bank from further violations of these provisions of the securities laws and OCC implementing regulations, and required the bank to file the required periodic reports in accordance with the requirements of the federal securities laws and regulations.

9. Conover v. Glenn, et al., C.A. No. 85-1208, U.S.D.C. D.C. (1985), involved a complaint for a permanent injunction against four individuals for violations of sections 13, 14 and 16 of the Exchange Act, to which the defendants consented, without admitting or denying the underlying allegations. The OCC in its complaint alleged that the individuals (1) acquired a beneficial ownership interest in approximately 9.9 percent of the shares of a national bank that were registered under the Exchange Act and failed to file required beneficial ownership reports; (2) acquired beneficial ownership of additional shares of bank stock and failed to file required statements of changes in beneficial ownership; and (3) solicited proxies by means of proxy solicitation materials in that such proxy statements were false and misleading and failed to contain required information under OCC regulations. The final order of permanent injunction enjoined the defendants from further violations of these provisions of the securities laws and OCC implementing regulations, and required the individuals to refile proxy solicitation materials with the OCC should those individuals still decide to seek election as bank directors.

10. SEC and OCC v. Charles D. Fraser, C.A. No. 84-2652, U.S.D.C. D.C. (1984), involved a complaint brought jointly by both the OCC and the SEC for permanent injunction, to which Fraser consented without admitting or denying any allegations. The complaint alleged that Fraser, while President of First National Bank of Midland, Midland, Texas, violated the antifraud provisions of the Securities Exchange Act of 1934, section 10(b), and rule 10b-5 thereunder promulgated by the SEC, and aided and abetted violations of Exchange Act section 13(a) and rules promulgated thereunder by the OCC at 12 C.F.R. Part 11. In particular, the OCC and SEC alleged that Fraser caused the bank, with a class of equity securities registered under the Exchange Act, to overstate its earnings and understate its allowance for loan and lease losses in its financial statements, and to fail to disclose adequately the risks in its loan portfolio for a number of reporting periods. The final order enjoined Fraser from further such violations of the Exchange Act.

Exchange Act Section 15B

1. In the Matter of First Bank (National Association), Milwaukee and James R. Wartinbee, Sr. (1991), a former senior vice president of the bank consented to a 12 month suspension from association with any municipal securities dealer or government securities dealer in any capacity. Moreover, the respondent agreed to take and pass the municipal securities representative and principal qualification examinations (series 52 and 53) administered by the NASD before becoming associated with any municipal securities dealer in any capacity. The OCC found that

Wartinbee had violated the antifraud and other provisions of the Securities Exchange Act of 1934 and rules of the Municipal Securities Rulemaking Board in connection with sales of securities to customers subject to oral put options. Further, the OCC had found that Wartinbee had made the securities sales while concealing from the bank the volume of securities sold subject to put and failing to make and keep current and adequate records of the transactions. Wartinbee's oral representations to customers to repurchase securities at the same price they had been sold, without disclosing the arrangement to the bank put the bank at financial risk and rendered the bank's records inaccurate and inadequate. Wartinbee also was found to have recommended transactions that were unsuitable for customers, improperly guaranteed customers against losses in certain securities transactions, improperly parked securities in customer accounts, shared in the profits generated in customer accounts which resulted in the charging of unreasonable fees to customers, and failed to disclose material facts to customers in connection with securities trades.

2. In the Matter of Bank of America, N.T. & S.A., et al. (1987), the OCC entered under authority of Exchange Act section 15B and made public an order to which all respondents consented, censuring Bank of America, N.T. & S.A., and requiring it to undertake certain remedial measures, for violations of the Exchange Act and rules of the Municipal Securities Rulemaking Board. The OCC found that, in connection with the conversion of the bank dealer department's securities trade processing and recordkeeping system, for at least six months the bank had engaged in securities trades with customers without disclosing that it was unable to maintain and keep current accurate and adequate books and records or an efficient back office operation. Further, the OCC found that, for over one year, the bank had issued safekeeping receipts in certain securities transactions, whereby the bank had sold securities to customer accounts through the issuance of due bills, but in fact had not purchased the securities for those customer accounts. The bank had engaged in the issuance of due bills and used customer funds without advising customers that it had not purchased securities for their accounts. The OCC also suspended for two to five days three supervisors, all qualified as municipal securities principals, for their failure to supervise with a view to preventing these violations.

3. In the Matter of __________ National Bank (1987).[1] Order issued pursuant to 12 U.S.C. § 1818, to which the bank consented without admitting or denying wrongdoing, for violations of 15 U.S.C. § 78o-4(c)(1) and Municipal Securities Rulemaking Board rules G-2, G-3, and G-27 in connection with purchases and sales of municipal securities while at least 24 dealer department employees were not properly qualified as municipal securities representatives or municipal securities principals, and failure to supervise bank employees committing the cited violations of law. The order required the bank to correct the cited violations of law and adhere to all applicable requirements of federal securities laws and MSRB rules, and to implement remedial measures designed to prevent recurrence of the cited violations.

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[1]The names of the parties have been omitted in private actions brought pursuant to 12 U.S.C. § 1818 prior to the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990.

4. In the Matter of First National Bank and Trust Company of Tulsa, Tulsa, Oklahoma, et al. (1985), the OCC entered under authority of Exchange Act section 15B and made public an order to which all parties consented, finding that the bank, through its municipal securities dealer department, as well as certain employees, violated the antifraud provisions of the federal securities laws and rules of the Municipal Securities Rulemaking Board by engaging in a variety of customer abuses. These violations included executing unauthorized trades for customer accounts, churning customer accounts, switching profits among accounts, salesmen sharing in customer profits, selling securities at off-market prices, and making unsuitable trades. The OCC also found that the bank and certain employees aided and abetted securities law violations and failed to supervise employees' violations of these provisions. The OCC censured the bank and imposed various remedial measures, and imposed various sanctions against individuals, including bars from acting in a supervisory capacity against several municipal securities principals, and censures, suspensions ranging from 10 to 30 days, and a bar against sales employees.

5. In the Matter of Merchants National Bank of Indianapolis, Indiana (1985), the OCC entered under authority of Exchange Act section 15B and made public an order to which all parties consented, censuring the bank and requiring the implementation of various remedial provisions arising from violations of the antifraud provisions of the federal securities laws and rules of the Municipal Securities Rulemaking Board through false valuations of the bank's municipal securities trading account, resulting in overstatements of bank income in call reports filed with the OCC and for failure to supervise employees committing such violations. The OCC also took action against various individuals, including censures, 30 and 45 day suspensions, and bars from serving in a supervisory capacity with a municipal securities dealer.

6. In the Matter of Thomas Grove (1985), the OCC entered under authority of Exchange Act section 15B and made public an order to which the respondent consented without admitting or denying the underlying allegations. Through the order the OCC censured the respondent and found that he willfully violated MSRB rule G-28 by failing to notify a registered broker-dealer that its employee had opened a trading account as a "customer" of Packers National Bank, Omaha, Nebraska.

7. In the Matter of Gary Lynn Moore (1985), the OCC entered under authority of Exchange Act section 15B and made public an order to which the respondent consented without admitting or denying the underlying allegations. Through the order the OCC suspended Moore from association with any municipal securities dealer for a period of 3 days for his willfully making a false statement relating to his prior disciplinary history in his application for qualification as a municipal securities representative.

Exchange Act Section 15C

1. In the Matter of the Distribution of Securities Issued by Certain Government Sponsored Enterprises (1992), the OCC, the FRB, and the SEC jointly brought enforcement actions against approximately 98 government securities brokers and dealers stemming from their participation in primary distributions of government sponsored enterprise securities. In connection with those distributions, the respondent banks failed to keep accurate records of customer orders for GSE

securities and/or offers, purchases, or sales by the respondent banks of such securities. The three agencies independently adopted comparable settlements with entities under their respective jurisdictions. They issued cease and desist orders for the recordkeeping violations and ordered the affected entities to develop and implement policies and procedures to prevent their recurrence. In addition, civil money penalties ranging from \$5,000 to \$100,000 were assessed based on the sales concessions received by the broker/dealers during a defined period. The civil money penalties assessed by the three agencies totaled \$5.165 million.

Exchange Act Section 17A

1. In the Matter of Citibank, N.A., New York, NY, AA-SCP-92-141 (1992), involved the bank's failure as a registered transfer agent to properly cancel and store up to 3500 boxes of securities with a face value of approximately \$111 billion, some of which were subsequently presented for payment. The bank further failed to report in a timely manner the lost securities. The OCC censured the bank and required it to adopt remedial measures, including: proper safeguarding of securities certificates in its possession; proper training of bank personnel involved in the securities cancellation and storage process; development of proper cancellation procedures, including perforation of securities certificates; hiring of an outside accountant to evaluate the bank's storage and cancellation processes; and adopting and implementing proper reporting procedures in the event misappropriated securities are discovered.

2. In the Matter of First National Bank of Boston (1990), involved an order to which the bank consented, without admitting or denying any wrongdoing, and which the OCC made public. The order, the first instituted by the OCC under authority of Section 17A, required the bank to undertake certain remedial measures for alleged violations of the Exchange Act and rules of the SEC applicable to registered transfer agents. The OCC alleged that the bank, through its corporate trust division, failed to (1) respond in a timely manner to customer inquiries concerning items presented for transfer, requests for confirmation of possession of certificates presented for transfer, and claims for interest payments; (2) maintain current adequate records of aged record differences, and inquiries received but not responded to; (3) accurately and promptly post and keep current security holder files and subsidiary files, maintain a control book, and resolve record differences; (4) report to the OCC buy-ins of securities for which it acted as transfer agent; and (5) assure that all securities held in safekeeping or its possession were handled properly.

3. Formal Agreement by and between ______ National Bank and the OCC (1985), involved the bank's failure to comply with certain transfer agent rules and OCC rules relating to fiduciary activities and required the bank, among other things, to; (1) perform studies and adopt procedures relating to the bank's fiduciary activities; (2) adopt procedures to and achieve compliance with transfer agent rules, including maintenance of appropriate records, notification of record differences, safeguarding of funds and securities, and fingerprinting requirements; (3) make reports to issuers of aged record differences; (4) obtain an independent accountant's report of internal accounting controls; (5) accept no new transfer agent business pending correction of deficiencies noted in the internal accountant's report; and (6) reimburse customers for lost earnings suffered as a result of the bank's failure to invest idle trust cash balances.

4. Agreement by and between ________ Bank & Trust Company, N.A. and the OCC (1983), involved the bank's failure to comply with certain transfer agent rules and required the bank to: document reconciliations of aged record differences of customer accounts, assure prompt processing, turn-around and forwarding of all items presented for transfer, adopt various remedial measures, perform management studies, and refrain from acting as transfer agent for any issuers other than those it already served prior to complying with all provisions of the agreement.

5. Agreement by and between ________ Bank of ________, N.A. and the OCC (1983), involved the bank's failure to comply with certain transfer agent rules and required the bank to: reconcile out of proof conditions in shareholder, general and subsidiary ledgers, document reconciliations of all shareholder accounts on the day of each transaction, resolve existing record differences, implement measures to assure prompt turnaround of items presented for transfer, complete a study of management quality and depth, implement measures to promptly and correctly respond to shareholder inquiries, implement measures to reflect changes in outstanding shares of client registered investment companies, prevent unauthorized access to transfer recordkeeping systems, improve controls over unissued certificates, and implement proper audit procedures for the transfer agent function.

12 U.S.C. § 1818

1. In the Matter of Michael A. O'Connell, Former President and Director of Metropolitan National Bank, McAllen, Texas (1993), involved a removal and order to make $219,108.88 in restitution. The bank's former president and director breached his fiduciary duties when he pledged without permission a bank customer's security as collateral to carry on unauthorized trading on margin in U.S. Treasury bonds, therby incurring substantial losses and substantially contributing to the bank's insolvency. In pledging the bank customer's security as collateral, the former president wrongly represented that he was acting as agent for the customer.

2. In the Matter of ________, ________, and ________. (1993) involved a memorandum of understanding entered jointly by the OCC and the FRB with two national banks and their parent holding company. The MOU addressed violations of 12 U.S.C. § 1972(1) where a national bank required a customer to use an affiliate national bank's securities services to obtain bank credit.

3. In the Matter of Donald Coleman, Former Chief Financial Officer, National Bank of Washington (1991), involved a violation of section 5 of the Securities Act of 1933, whereby the CFO, Donald Coleman, was fined $55,000 for permitting the bank to sell unregistered holding company commercial paper after its correspondent banks withdrew their backup lines of credit, making the commercial paper no longer eligible for exemption from registration. The bank failed to notify purchasers of this fact and, when the holding company was unable to meet its obligations, the purchasers were left with worthless commercial paper.

4. In the Matter of Thelma Elizabeth Pollard, National Bank of Washington (1991), involved a violation of section 17(a) (fraudulent securities sales) of the Securities Act of 1933,

whereby a bank trader, Thelma Elizabeth Pollard, fraudulently transferred customer funds from certificates of deposit into commercial paper to meet the holding company's funding needs. The OCC assessed a $1,000 CMP against Pollard and removed her from banking for a term of two years. The removal also bars her from ever working in a bank trading department or trust department.

5. In the Matter of L.P. Palumbo, (1991), the OCC assessed a $5000 civil money penalty against Mr. L.P. Palumbo, President of Progressive National Bank of DeSoto Parish, Mansfield, Louisiana, for causing the Bank to distribute an offering circular which had not been declared effective by the OCC pursuant to 12 C.F.R. Part 16. In addition, Mr. Palumbo caused the Bank to offer securities in five nonpublic offerings without filing required notices with the OCC. The OCC found that the securities offered through the nonpublic and public offerings exceeded the number of shares authorized by the Bank's Articles of Association. The Bank subsequently rescinded the offerings, returned subscriptions for the unauthorized stock, and reduced the capital accounts of the Bank.

6. In the Matter of ________ National Bank, (1990) involved formal agreements with two national banks under authority of 12 U.S.C. § 1818. The banks agreed, among other things, to ensure that in-house sweep account programs to sell parent holding company commercial paper or other obligations comply with federal securities laws, including requirements to make adequate disclosures to customers, and OCC examining guidelines. The banks also agreed to provide notice to the OCC and seek its prior review before reintroducing any sweep account program involving commercial paper.

7. Agreement by and between ______ Bank, N.A. and the OCC (1988) involved the bank's (1) sale of various securitized assets in a manner which prompted the OCC to cite the bank for having violated the antifraud provisions of the federal securities laws and (2) sale of unregistered securities in violation of the Securities Act of 1933. The banks agreed to engage counsel to conduct various internal studies of these sales practices and provide customers the opportunity to rescind such purchases, and adopt policies to prevent the-recurrence of such practices.

8. Formal Agreements by and between ____ and ____ and the OCC. (1987). Formal agreement issued under authority of 12 U.S.C. § 1818, to which the individuals consented without admitting or denying any wrongdoing, for violations of the antifraud provisions of the federal securities laws. The violations arose in connection with the use by the individuals, formerly bank employees, of customer securities, purchased and held through the bank's discount brokerage operation, as margin to cover options trading obligations of the individuals. Pursuant to the orders, the individuals agreed to cease to act for a period of eleven months in any position in the bank or any other financial institution involving the purchase or sale of securities, the provision of fiduciary services to the public, or the handling of customer trust funds or securities.

9. In the Matter of ______ (1985) involved the assessment of a civil money penalty against an individual for alleged failure to comply with the prior notice requirements of the Change in Bank Control Act of 1978, 12 U.S.C. § 1817(j), in connection with his acquisition of more than 10

per cent of the stock of an insured national bank. The individual consented to the order without admitting or denying having violated the act. The OCC suspended its collection of the penalty based on the individual's prior divestiture of bank stock to a level that would not constitute a control interest in the subject bank and his agreement not to purchase any stock in any insured bank without first complying with the prior notice requirements of the act. Should the individual subsequently be found to have violated the act within five years of the date of the order, he agreed that he would pay the suspended penalty ($10,000) plus any other penalty that may be assessed.

10. In the Matter of ______ National Bank, (1985) involved a national bank's issuance of securities in violation of the OCC's securities offering disclosure rules (12 C.F.R. Part 16) in connection with the bank's initial offering of securities prior to the bank's opening. The OCC ordered the bank, which consented to the issuance of the order, not to engage in any acts or practices constituting violations of Part 16 by offering or selling securities without complying with the requirements of Part 16, or by utilizing an offering circular which is false and misleading in any material respect.

11. In the Matter of the First National Bank of Maryland, Baltimore, Maryland, (1984) involved an order to which the bank consented without admitting or denying any wrongdoing, the existence of which the OCC made public through a press release. Pursuant to the order, the bank was required to refrain from borrowing or lending customer securities unless it first complied with a number of conditions, including clarifying lending disclosures to securities customers in safekeeping agreements, obtaining customer authorization prior to borrowing or lending customer securities held in safekeeping, implementing policies addressing accounting and managerial controls over the securities lending function, developing fee sharing schedules for securities lending for safekeeping customers whose securities are being lent, and conducting a study to identify and compensate safekeeping customers whose securities were loaned or borrowed between January 1982 and June 1984.

Attachment F

BC - 245

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: SEC Financial Institution Task Force

TO: Chief Executive Officers of all National Banks; Deputy Comptrollers; District Counsel; and all Examining Personnel

SUMMARY

This circular advises national banks of new initiatives undertaken by the Securities and Exchange Commission (SEC) on disclosure requirements and enforcement actions under federal securities laws. The circular also describes the assistance which the Office of the Comptroller of the Currency (OCC) is providing to the SEC.

SEC INITIATIVES

The SEC has recently formed two task forces that will focus on compliance with federal securities laws by financial institution holding companies that operate under the SEC's jurisdiction. The task force located in the SEC's Division of Corporation Finance will concentrate on reviewing disclosures by registered financial institution holding companies under the Securities Exchange Act of 1934 (Exchange Act) and disclosures related to securities offerings under the Securities Act of 1933 (Securities Act). The task force located in the SEC's Enforcement Division will investigate and prosecute allegations of noncompliance by financial institution holding companies under the federal securities laws.

1. SEC Disclosure Review Task Force

National banks which are subsidiaries of bank holding companies should be aware that the SEC has requested the assistance of the OCC (and the other federal banking regulatory agencies) in reviewing the adequacy and accuracy of Exchange Act and Securities Act disclosures filed with the SEC by registered financial institution holding companies. In response to this request, the OCC is undertaking a limited review of these disclosures referred by the SEC as they relate to any subsidiary national banks.

As part of its initiative to review disclosures by financial institution holding companies, the SEC has announced several specific areas that will be emphasized:

- o Adequacy of disclosure of administrative actions taken by banking regulators;
- o Treatment of loan loss reserves in disclosures, including the accuracy, adequacy and timeliness of charges;
- o Adequacy of disclosures related to the investment portfolio, including proper accounting for trading;
- o Accuracy of disclosures related to highly leveraged transaction lending and real estate lending;
- o Accuracy of disclosures of compensation and insider transactions including loans to insiders; and,
- o Adequacy of disclosures related to supervision and regulation of financial institution subsidiaries, including material aspects of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

2. SEC Enforcement Task Force

The new task force on financial institution holding companies in the SEC's Enforcement Division has announced that it will emphasize these areas:

- o Any allegations of noncompliance by holding companies with disclosure requirements, including violations of the antifraud provisions, failure to disclose insider transactions and other disclosure problems which may be identified by the Division of Corporation Finance task force;
- o Sales by financial institutions on public premises of the institutions' own securities or their affiliates' securities, particularly the adequacy of disclosure that the security is not a government insured deposit; and,

- o Securities trading by financial institution insiders based on nonpublic information obtained from such institution's customers (particularly in connection with arranging financing in corporate mergers and acquisitions), and also trading in a financial institution's own securities by its insiders prior to the release of material nonpublic information concerning the condition of such institution.

OCC'S SECURITIES PROGRAM

The OCC also continues to conduct its own comprehensive disclosure review and enforcement program for national banks' securities offerings and for periodic filings by national banks that are registered with the OCC under the Exchange Act (See BC 213). The OCC's enforcement authority under the Exchange Act is found primarily in Section 12(i) (registration and periodic reporting requirements, Williams Act and certain insider transactions reports and prohibitions). The OCC has additional enforcement authority under the Exchange Act relating to other securities activities of national banks in Section 15B (municipal securities dealers); Section 15C (government securities brokers and dealers); and Section 17A (clearing agents and transfer agents). The OCC also has authority to enforce compliance with any law or regulation, including the securities laws, under 12 U.S.C. 1818(b). Under this authority, the OCC enforces compliance with its rules on securities offering disclosure at 12 C.F.R. Part 16.

When the OCC uncovers incidents of noncompliance with the securities laws which are not under this agency's jurisdiction, the OCC will continue its practice of referring allegations to the SEC and cooperating with the SEC's investigation and prosecution. The OCC will also continue its policy of providing the SEC with full and prompt access to relevant information collected and maintained by the OCC under the OCC's separate statutory authority when (1) the SEC has reason to believe that a violation of law under the SEC's jurisdiction has occurred; and, (2) the SEC agrees to maintain appropriate confidentiality with regard to any relevant OCC information.

BC-245

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular | Subject: SEC Financial Institution Task Forces

Additionally, as discussed above, the OCC has added a new element to its securities program in response to the SEC's recent request for assistance in reviewing bank holding company securities disclosures. The OCC is now assisting the SEC by conducting limited disclosure review, as requested by the SEC, of bank holding company filings under the federal securities laws for those companies with national bank subsidiaries.

ORIGINATING OFFICE

Questions concerning this Banking Circular should be directed to the Office of the Comptroller of the Currency, Securities and Corporate Practices Division, Washington, D.C. 20219 (telephone (202) 447-1954).

Dean Marriott
Dean Marriott
Senior Deputy Comptroller of the Currency

Congress of the United States
House of Representatives
Washington, DC 20515

December 20, 1993

Mr. Frank V. Cahouet
Chairman
Mellon Bank Corporation
One Mellon Bank Center
Pittsburgh, PA 15258

Mr. Howard Stein
Chairman
The Dreyfus Corporation
200 Park Avenue
New York, N.Y. 10166

Dear Messrs. Cahouet and Stein:

Pursuant to Rules X and XI of the Rules of the U. S. House of Representatives, and our continuing oversight, respectively, of banks and banking, including deposit insurance, and of securities and exchanges, we are writing in regard to the proposed acquisition of The Dreyfus Corporation (Dreyfus) by Mellon Bank Corporation (Mellon Corp.). This proposed transaction raises numerous legal and public policy concerns. While we have received initial briefings about the transaction from various representatives of Mellon Corp. and Dreyfus, we have a series of questions we would like you to address in order to help us to evaluate the proposed transaction and the appropriate regulator's review of it.

1. Please describe in detail the structure of the transaction, indicating where each current subsidiary of and/or function performed by Dreyfus will be housed in Mellon Corp. or any of its subsidiaries. Describe which Dreyfus subsidiaries and/or functions will be divested.

2. What regulatory applications or notifications will be required? When do you plan to submit such applications or notifications?

3. A briefing paper (copy attached) provided to us by Mellon Corp. states that, "Dreyfus' distribution function will be sold to an independent, third party distributor." Please elaborate, including a detailed description of how the distributor will be independent of Mellon Corp. and any of its subsidiaries, including the Dreyfus' funds' investment adviser, administrator and custodian.

4. The briefing paper makes reference to a Policy Statement to be created by Mellon Corp. addressing consumer protection, conflicts of interest, including independence of the various entities involved, and safety and soundness of the bank and the funds. Please provide us with the most recent draft of that policy statement.

5. Please describe any meetings or discussions you or any representatives of your respective organizations may have had with any State or Federal regulators regarding the proposed transactions, including the date of the meetings, the attendees, and a summary of the discussion.

Please provide the requested information to our Committees by the close of business on Friday, January 7, 1994.

Sincerely,

Henry B. Gonzalez
Chairman
Committee on Banking,
Finance and Urban Affairs

John Dingell
Chairman
Committee on Energy
and Commerce

Rec'd 1-7-94
4:25 PM

January 7, 1994

The Honorable John D. Dingell,
Chairman,
Committee on Energy and Commerce,
2125 Rayburn House Office Building,
Washington, D.C. 20515.

Re: Mellon Bank Corporation/The Dreyfus Corporation

Dear Chairman Dingell:

We are writing to respond to your letter to us, dated December 20, 1993, regarding the merger agreement between The Dreyfus Corporation ("Dreyfus") and Mellon Bank Corporation ("Mellon"). We hope that our responses will deal satisfactorily with the legal and public policy concerns set forth in your letter.

1. The structure of the transaction. Under the terms of the merger agreement, Dreyfus will merge with a subsidiary of Mellon Bank, N.A. ("Mellon Bank"), which is the principal subsidiary of Mellon. As a consequence, Dreyfus will become an operating subsidiary of Mellon Bank. The various Dreyfus subsidiaries and operations will simultaneously be dealt with as follows:

(i) The principal operating Dreyfus subsidiaries will be acquired by Mellon Bank. These subsidiaries will thereby become operating subsidiaries of Mellon Bank, pursuant to 12 C.F.R. § 5.34. The principal functions of these subsidiaries are to

provide investment advice and related administrative services to registered investment companies.

(ii) Several other Dreyfus subsidiaries will become subsidiaries of Mellon or other Mellon subsidiaries.

(iii) Certain other subsidiaries and operations will be transferred to independent third parties or discontinued. Operations in this third category include the distribution function for the Dreyfus Funds. Annex A contains a complete list of these subsidiaries.

The structure of the transaction is consistent with the basic business structure of Mellon. The retail operations of the Corporation are centered in Mellon Bank, with an emphasis on providing the most convenient and efficient services to consumers. Accordingly, Dreyfus, the services of which are directed to the retail market, will be a subsidiary of Mellon Bank.

Adoption of this structure will enable Mellon Bank to utilize, for regulatory and accounting purposes, the strong capital base that Dreyfus has accumulated, while at the same time insulating Mellon Bank by application of Sections 23A and 23B of the Federal Reserve Act. A national bank and its subsidiaries file consolidated financial data. Accordingly, the proposed transaction will enable Mellon Bank to increase its various capital ratios by over 200

basis points. In addition, Mellon Bank's earnings will be significantly enhanced by Dreyfus' earnings, and Mellon Bank's capital will be further increased by Dreyfus' future retained earnings.

The importance of enhanced capital at the bank level has extended beyond general standards of prudence and safety and soundness. Under the Federal Deposit Insurance Corporation Improvement Act of 1991, a host of statutory and regulatory requirements relate to a bank's capital level. These include the assessment rate for deposit insurance premiums, interbank liability exposures, and restrictions on interest rates on deposits, brokered deposits and pass-through deposit accounts. The combined effect of these provisions has been to place a high premium on maintenance of a very high level of capital at each bank subsidiary.

A further reason for maintenance of a high level of capital and high earnings at the bank level is the increasing importance of various rating agencies which rate bank deposits for safety and publicize (or make available to the public) their ratings. These ratings are based on call report data and are heavily affected by a bank's reported capital and earnings. The ratings can significantly influence a bank's cost of funds and, in a number of cases, are determinative of whether a particular customer (individual, corporation or institution) will maintain any deposits with the bank.

Finally, the increased capital at Mellon Bank will increase Mellon Bank's capacity to make loans and thereby contribute to an economic recovery.

These important business advantages could not be attained if Dreyfus were a subsidiary of Mellon rather than of Mellon Bank. This would be true even if Dreyfus' capital were paid out as a dividend to Mellon, which then contributed that capital to Mellon Bank. In the first place, such an approach would strip Dreyfus of its capital and thereby reduce the substantial protection provided by that capital to shareholders of the Dreyfus Funds. In addition, if Dreyfus' earnings were not consolidated with those of the Bank, the ratings of the Bank's deposits could suffer. Finally, Mellon's retail services to consumers would be dispersed rather than made more efficient.

2. <u>Regulatory applications and notifications</u>. Regulatory applications and notifications have been filed with the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision. Notifications for the subsidiaries listed in Part I of Annex A were filed with the Comptroller pursuant to 12 C.F.R. § 5.34. Applications for the subsidiaries listed in Part II of Annex A were filed with the Federal Reserve Board pursuant to Section 4(c)(8) of the Bank Holding Company Act. An application to acquire Dreyfus Security Savings Bank was filed with the OTS. The

notification to the Comptroller was filed on December 30, 1993, and the applications to the Federal Reserve Board and OTS were filed on January 3, 1994. An application for the subsidiaries listed in Part III of Annex A will be filed with the Federal Reserve later in January. As noted in Mellon's notification to the Comptroller and in Part IV of Annex A, a number of other Dreyfus subsidiaries will not be acquired and will be liquidated or divested.

3. Independence of the distributor for the Dreyfus Funds. The third party distributor for the Dreyfus Funds will be independent of Mellon and its subsidiaries (including the Dreyfus Funds' investment advisor, administrator and custodian) for the following reasons:

(i) Neither Mellon nor Dreyfus will own any shares of stock of, or any other security issued by, the third party distributor.

(ii) Neither Mellon nor Dreyfus will have any interest in the profits or earnings of the third party distributor.

(iii) There will be no director, officer or employee interlock between Dreyfus and the third party distributor.

4. Policy Statement. A copy of the Policy Statement is contained at Tab 5 of the Mellon Bank notice to the Comptroller of the Currency, copies of which have been previously delivered to your Committee's counsel. An

additional copy is enclosed for your convenience. This Policy Statement is designed, among other things, to be responsive to a number of the current legislative proposals.

5. Meetings and discussions with regulatory agencies.* Meetings or discussions were held with both the Office of the Comptroller of the Currency and the Federal Reserve System in early November, 1993, shortly prior to an anticipated announcement of a transaction between Mellon and Dreyfus, and then again in early December, 1993, shortly prior to the announcement of the actual transaction. These meetings were consistent with Mellon's standard operating procedure (which we believe most banking organizations follow) of always informing their bank regulators in advance of the announcement of a major transaction.

The specific meetings/discussions (to the best of our representative's recollections) were the following:

(i) Meeting on November 3, 1993, among Steve Elliott (Vice Chairman and Chief Financial Officer) and Mike Hughey (Controller) of Mellon, Wayne Pentrack and John Shanahan of KPMG Peat Marwick and the following accounting staff of the Securities and Exchange

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* The information in response to this question was provided by representatives of Mellon and Dreyfus who attended the meetings or participated in the telephone discussions; neither Mr. Cahouet nor Mr. Stein attended any of the referenced meetings or (except as provided specifically below) participated in any of the telephone conversations.

Commission, John Riley, Christopher Holmes, John Glynn, James Boatsman, Kurt Hohl, and Teresa Iannaconi regarding the accounting treatment for a large transaction involving Mellon and an unidentified party.

(ii) Telephone conversation on November 4, 1993, among Mr. Elliott and Mr. Pentack and Mr. Riley and Mr. Holmes of the Securities Exchange Commission in follow-up to the previous day's meeting.

(iii) Telephone conversation in early November, 1993 between Rodgin Cohen of Sullivan & Cromwell and William Bowden, General Counsel of the Office of the Comptroller of the Currency, regarding the Comptroller's prior letters on bank mutual fund activities, in which the potential of a large mutual fund transaction was referenced but not identified.

(iv) Meeting on November 5, 1993 at the offices of the Comptroller of the Currency. Attendees: Mellon - Michael Bleier (General Counsel), Keith Smith (a Vice Chairman) and Steve Elliott; Dreyfus - Daniel Maclean (General Counsel); Sullivan & Cromwell - Rodgin Cohen; Comptroller of the Currency - Jimmy Barton, William Bowden, Steve Weiss and other members of the Comptroller's staff. The Comptroller, Eugene Ludwig, joined the meeting near the end. At this meeting, Mellon verbally presented an outline of the possible framework and the business rationale for the

transaction and an overview of the legal analysis. The staff of the Comptroller asked questions regarding each of these aspects of the transaction. This meeting was set up in a conversation between Messrs. Bleier and Bowden on November 3.

(v) Telephone conversation on November 6, 1993 between Mr. Bleier and Jack Wixted of the Federal Reserve Bank of Cleveland. Mr. Bleier outlined the proposed transaction and the business rationale.

(vi) Telephone conversations on November 8 and 10, 1993 with the legal staff of the Federal Reserve Board. Participants in the first telephone conversation were Messrs. Bleier and Cohen and J. Virgil Mattingly, General Counsel of the Federal Reserve Board. Participants in the second telephone conversation were Messrs. Bleier, Mattingly, and Scott Alvarez and Richard Ashton of the Federal Reserve Board Legal Division. In the first discussion, Messrs. Bleier and Cohen presented an outline of the framework and business rationale for the transaction and a legal analysis. In the second discussion, the focus was the legal aspects of the transaction.

(vii) Telephone conversation on November 8, 1993 between Mr. Bleier and Jim Vesely, the Comptroller's examiner-in-charge at Mellon Bank. Mr. Bleier outlined the proposed transaction.

(viii) Conversation on November 10, 1993 between Mr. Cahouet and Wixted in which Mr. Cahouet mentioned that negotiations were still in process.

(ix) Telephone conversations on November 11, 1993 between Mr. Cohen and Mr. Bowden, between Mr. Cohen and Mr. Mattingly, between Mr. Bleier and Mr. Wixted and between Mr. Cahouet and Jerry Jordan, President of the Cleveland Federal Reserve Bank, and Mr. Wixted, in which the Federal Reserve and Comptroller were informed that negotiations for the transaction had been terminated.

(x) Telephone conversation on or about November 15, 1993 between Joni L. Charatan of Dreyfus and Donald Hom, Examiner, Northeastern Regional Office of the Office of Thrift Supervision ("OTS"), regarding newspaper articles concerning termination of possible merger discussions between Dreyfus and Mellon.

(xi) Brief telephone conversations between Mr. Cohen and Robert Serino, Deputy Chief Counsel of the Comptroller, on December 3, 1993, between Mr. Bleier and Mr. Vesely on December 3 and December 5, between Mr. Bleier and Mr. Wixted on December 3 and December 5, between Mr. Bleier and Mike Carnovali (of the Northeastern District Office of the Comptroller of the Currency) on December 3 and December 5, between Mr. Cohen and Mr. Mattingly on December 4, and between

Mr. Cohen and Mr. Bowden on December 5. In each conversation, Mr. Cohen or Mr. Bleier informed the bank regulatory agency that negotiations had resumed between Mellon and Dreyfus and that public announcement of a transaction could occur as early as the morning of December 6, 1993. There was also a brief telephone conversation between Mr. Cahouet and Jerry Jordan on December 5, 1993 in which Mr. Cahouet informed Mr. Jordan that the Mellon Board of Directors had approved the transaction.

(xii) Telephone conversation on December 6, 1993 between Martin McGuinn (a Vice Chairman of Mellon) and a secretary to Frank Newman, Under Secretary of the Treasury Department, in which Mr. McGuinn left a message relating to the announcement of the transaction.

(xiii) Telephone conversations or messages on December 6 or 7 between Mr. Bleier and members of the Bank Supervision and Regulation staffs of the Federal Reserve Banks of Boston, Cleveland, Philadelphia, Richmond and New York, as well as the Maryland Banking Commission, Pennsylvania Banking Department and the Massachusetts Department of Banking informing them that a public announcement of the transaction had been made.

On or shortly after December 6, Mr. Bleier also had brief and separate telephone conversation with

Mr. Bowden, Mr. Vesely and Karen Wilson (Deputy Comptroller) regarding the announcement of the transaction.

(xiv) Telephone conversation on December 6, 1993 among William V. Healey and Tim Murphy of Dreyfus and Donald Hom of the Northeastern Regional Office of the OTS regarding the announcement of the merger transaction and the potential impact of the merger on The Dreyfus Security Savings Bank, F.S.B., a federally-chartered savings bank ("Dreyfus FSB").

(xv) Meeting on December 7, 1993 between Messrs. Bleier and Cohen and Messrs. Mattingly, Alvarez and Ashton of the Federal Reserve Board legal staff in which the legal aspects of the transaction were discussed.

(xvi) Telephone conversation on December 7, 1993 among Messrs. Healey, Murphy and Hom regarding the application process for the acquisition by Mellon of Dreyfus FSB, and registration by Mellon as a savings and loan holding company. Issues relating to an application by Dreyfus FSB for trust powers and previously authorized interstate branches were also discussed.

(xvii) Telephone conversation on December 8, 1993 between Mr. Healey and David Kahn, Principal Bank Examiner II, New York State Banking Department,

regarding the application process for the acquisition by Mellon of The Dreyfus Trust Company, a limited purpose trust company formed under the New York State Banking Law.

(xviii) Telephone conversations on December 8, 1993 between Messrs. Elliott and Vesely and Messrs. Elliott and Wixted to discuss the financial aspects of the transaction.

(xix) Telephone conversation on December 8, 1993 among Mr. Healey, John Buchman of Alston & Bird, and Julie L. Williams, Deputy Chief Counsel of the Office of the Comptroller of the Currency, regarding certain issues that may arise from the transaction relating to Dreyfus FSB.

(xx) Brief meeting on December 13, 1993 between Mr. Healey and Jonathan Fiechter, Acting Director of the OTS, following a meeting of the Association of Financial Services Holding Companies in Washington, D.C. Mr. Fiechter was informed that Dreyfus and Mellon had entered into an Agreement and Plan of Merger and that a meeting was going to take place in the Northeastern Regional Office of the OTS with Angelo A. Vigna, Regional Director of the OTS, later in the week.

(xxi) Brief discussion on December 15, 1993 between Messrs. Bleier and Alvarez regarding the framework of the transaction.

(xxii) Telephone conversations between Messrs. Bleier and Cohen and Mr. Wixted, Andrew W. Watts and R. Chris Moore of the Cleveland Federal Reserve Bank on December 15 and 16, 1993 in which Messrs. Bleier and Cohen explained certain framework and legal aspects of the transaction.

(xxiii) Meeting on December 16, 1993 between Mr. Elliott and Mr. Vesely to discuss the financial aspects of the transaction.

(xxiv) Meeting on December 16, 1993 in the Northeastern Regional Office of the OTS among Messrs. Bleier and Healey, and Ms. Charatan, as representatives of Mellon and Dreyfus, and Mr. Vigna, Michael Simone, Charles O'Toole, Ellen Kulka, Douglas Cestone and Donald Hom of the OTS Northeastern Regional Office. The meeting related to the transaction generally, and the impact on Dreyfus FSB in particular. The required federal and state applications required for the transaction were also discussed, with the focus being on the OTS application process.

(xxv) During the period December 16 to December 23, 1993, Ms. Charatan received a telephone call from Howard Bluver, Deputy Chief Counsel for Corporate Transactions at the OTS in Washington, D.C. Mr. Bluver asked that Dreyfus keep his office apprised of the status of the proposed transaction. He also answered

several questions regarding the regulations imposed on savings and loan association holding companies.

(xxvi) Meeting on December 17, 1993 among Mr. Healey and Joseph Callahan, Principal Bank Examiner, and Preneus Antoine, Examiner, New York State Banking Department. The meeting took place in Uniondale, New York, following an exit interview relating to the New York State Banking Department's examination of The Dreyfus Trust Company. The transaction was discussed in general terms. Also discussed was the potential impact of the merger on the future operations of The Dreyfus Trust Company.

(xxvii) Meeting on December 20, 1993 between Messrs. Smith, Bleier and Cohen and Messrs. Barton, Bowden, Owen Carney, Zane Blackburn, David Apgar, Robert Inskeep and others of the Office of the Comptroller of the Currency in which financial, operational, controls and management aspects of the transaction were discussed.

(xxviii) During the week of December 20, 1993, a telephone conversation took place between Mr. Healey and David Kahn, Principal Bank Examiner, New York State Banking Department, during which Mr. Kahn confirmed that Mellon must file an application under Section 142 of the New York State Banking Law relating to the acquisition of The Dreyfus Trust Company.

(xxix) During the period December 20 to December 31, 1993, Ms. Charatan spoke to Garry Cox at the Utah Department of Financial Institutions as to whether anything needed to be filed with that office to reflect the proposed change of control of Dreyfus Thrift & Commerce, an inactive Utah-chartered industrial loan corporation.

(xxx) During the period December 20 to December 31, 1993, Ms. Charatan spoke with representatives of the New York State Banking Department as to whether anything needed to be filed with that office to reflect the possible change of control of The Dreyfus Consumer Credit Corporation, a New York-licensed mortgage banker. Ms. Charatan also spoke with David Weikert at the State of New Jersey Department of Banking as to whether anything needed to be filed with that office to reflect the proposed change of control of Dreyfus FSB and The Dreyfus Trust Company, an inactive New Jersey-chartered trust company.

(xxxi) Meeting on December 22, 1993 between Mr. Maclean and Barry Barbash, Director of the Division of Investment Management of Securities and Exchange Commission, and other members of the Commission staff at which Mr. Maclean explained the framework and business rationale for the transaction.

(xxxii) A brief telephone conversation on December 22 or 23, 1993 between James Gockley, Assistant General Counsel of Mellon, and Jack Murphy, Branch Chief of the Securities and Exchange Commission, to discuss the registration statement for the transaction.

(xxxiii) Telephone conversations between Mr. Wixted and Mr. Bleier and between Mr. Wixted and Mr. Frank Cahouet on December 23, 1993 regarding the framework of the transaction.

(xxxiv) On December 27, 1993, Kevin Mawe of Mellon's legal department spoke with Ms. Detwiler (Chief Counsel, Pennsylvania Department of Banking) as to whether Mellon would require approval to acquire The Dreyfus Savings Bank. In a telephone call of January 6, 1994, Ms. Detwiler confirmed that no such approval is required under Pennsylvania law.

(xxxv) Telephone conversation between Mr. Mattingly and Mr. McGuinn on December 28 regarding the framework of the transaction and the timing of the filing with the Comptroller.

We also understand that Mr. Wixted attended by telephone a telephonic analyst presentation held on December 6 regarding the transaction.

It is possible that the foregoing descriptions may have omitted one or several attendees from the regulatory agency. It is also possible that several of the telephone

discussions may have occurred on a date slightly different than the date indicated above, and that there may have been other telephone conversations involving other subjects in which there was a brief or casual reference to the Mellon-Dreyfus transaction.

In addition to the meetings and conversations specifically identified above, there have occurred contacts between Mellon or Dreyfus personnel and staff members of the Office of the Comptroller, the Federal Reserve Bank of Cleveland, the OTS and state authorities to discuss application mechanics and similar procedural issues. Moreover, Mellon staff have meetings or conversations with the resident examiner, Mr. Vesely, and Mr. Wixted on an ongoing basis. Dreyfus-related issues are discussed at those meetings or conversations from time to time.

* * *

We are also forwarding for your information a copy of the public portions of the Notice that Mellon filed on December 30, 1993 with the Comptroller. We believe that this Notice contains information that may be relevant to your inquiries.

We hope that the foregoing is responsive to your inquiries. If there is anything we can do to assist you further, please feel free to call either of us.

Very truly yours,

Frank V. Cahouet

Howard Stein

cc: Chairman Gonzalez

ANNEX A

Annex A, Part I

Dreyfus Companies That Will Become Operating Subsidiaries of Mellon Bank, N.A.

The Dreyfus Corporation acts as investment adviser and administrator to Mutual Funds.

The Dreyfus Consumer Credit Corporation does not engage in any business other than holding loans that were made in 1992.

Dreyfus-Lincoln, Inc. is the second-tier holding company of Dreyfus Security Savings Bank, F.S.B. and will remain a subsidiary of The Dreyfus Corporation so that payments received under a noncompetition agreement can be credited to Dreyfus.

Dreyfus Management, Inc. provides investment advisory services to, among other, corporate retirement plans, individuals, foundations & endowments. It is registered with the U.S. Securities and Exchange Commission and in 17 states as an investment adviser.

Dreyfus Personal Management, Inc. offered discretionary advisory services primarily to individuals; it became inactive as of July 1, 1993, and does not currently have any clients. It is registered with the U.S. Securities and Exchange Commission and in 7 states as an investment adviser.

Lion Management, Inc. is registered with the Commodity Futures Trading Commission and the National Futures Association as a commodity pool operator and commodity trading adviser.

Dreyfus Precious Metals, Inc. is in the business of investing and selling to its customers certain precious metals, such as gold, silver and platinum bullion, American gold eagle coins and Canadian maple leaf coins.

Dreyfus Service Corporation currently serves as distributor of Dreyfus managed and/or administered mutual funds pursuant to the terms of a distribution agreement with each fund. It is registered with the U.S. Securities and Exchange Commission, the National Association of Securities Dealers, Inc. and all fifty states as a broker-dealer. Upon the consummation of the transaction, the distribution function

will be transferred to an independent third party and the company's activities will conform to those permissible under the Glass-Steagall Act.

Seven Six Seven Agency, Inc. serves as Dreyfus' in-house advertising agency.

Dreyfus Company That Will Become an Operating Subsidiary of Mellon Bank (DE) National Association

Dreyfus Service Organization, Inc. serves as agent in the sale of variable annuity products issued by Transamerica Occidental Life Insurance Company and First Transamerica Life Insurance Company. It is licensed as an insurance agent in thirty-three states. It will become a subsidiary of Mellon Bank (DE) or a subsidiary of MBC Insurance Agency, a subsidiary of Mellon Bank (DE), located in the town of Lewes, Delaware, a town with a population of fewer than 5,000 persons.

Annex A, Part II

Dreyfus Companies That Will Become Non-Bank Subsidiaries of MBC (Application for Approval Filed January 3, 1994)

The Dreyfus Security Savings Bank, F.S.B. is an FDIC-insured federal savings bank with approximately $40 million in assets.

The Dreyfus Trust Company is a New York limited purpose trust company.

Annex A, Part III

Dreyfus Companies That Will Become Non-Bank Subsidiaries of MBC (Application to be filed later in January)

Dreyfus Acquisition Corporation is used, from time to time, by Dreyfus to make equity and debt investments. Its holdings will be reduced or liquidated following consummation of the transaction.

Major Trading Corporation engages primarily in investing and trading in securities for its own account. Its holdings will be reduced or liquidated following consummation of the transaction.

Dreyfus Partnership Management, Inc. serves as non-managing general partner of Dreyfus-managed funds organized as limited partnerships. Its interests do not represent more

than 5 percent of the outstanding voting shares of any company.

Dreyfus Realty Advisors, Inc. engages in the business of providing investment advisory services relating to the acquisition, management, and disposition of real estate and real estate related investments.

The Trotwood Corporation and its subsidiary, The Trotwood Hunters Site A Corporation, are designed to assist in the development of a major governmental/private enterprise real estate project in New York City know as "Queens West".

The Truepenny Corporation is the parent corporation of The Trotwood Corporation.

Annex A, Part IV

Dreyfus Companies That Will Be Liquidated or Divested

Dreyfus Consumer Life Insurance Company is an insurance company that was originally intended to provide services in connection with universal life insurance business. The company does not currently write any insurance business, but is licensed in thirty states. It is anticipated that the company will be sold prior to closing or as soon thereafter as practical.

Dreyfus Garden City, Inc. is the holding company of The Dreyfus Trust Company. It is anticipated that this company will be liquidated.

The Dreyfus Holding Corporation is the holding company of Dreyfus Thrift & Commerce, a Utah-chartered industrial loan company that became inactive on March 1, 1993 when its assets and liabilities were transferred to Dreyfus Security Savings Bank. It is anticipated that this company will be liquidated.

Dreyfus Media, Inc. may sponsor television or radio programs or events and engage in other communications-related activities involving the financial services industry, including Dreyfus Funds.

The Dreyfus Trust Company holds a New Jersey trust company charter but has never been activated.

Dreyfus Canada, Inc. acts as the exclusive agent for the sale of Dreyfus International Investment Programs and as distributor of the shares of The Dreyfus Fund International Limited.

Dreyfus Sales of Canada, Ltd. has never commenced operations.

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

January 28, 1994

Mr. Frank V. Cahouet
Chairman
Mellon Bank Corporation
One Mellon Bank Center
Pittsburgh, Pennsylvania 15258

Mr. Howard Stein
Chairman
The Dreyfus Corporation
200 Park Avenue
New York, New York 10166

Dear Messrs. Cahouet and Stein:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

In December, representatives of your institutions were advised that the Subcommittee would be looking into this transaction and that hearings would be scheduled in the near future. As a starting point, we have reviewed the copy of the Notice of the transaction and supporting documentation that was delivered to the Committee on Energy and Commerce on January 3, 1994 as well as your letter of January 7, 1994 responding to the December 20, 1993 Gonzalez-Dingell letter. In order to assist the Subcommittee in its investigation and in preparation for the upcoming hearings, your cooperation is requested in providing the following responses, information, and documents by the close of business on Friday, February 18, 1994.

1. Your January 3 transmittal letter states that you have enclosed "a copy of the <u>public</u> portion of the Notice that was filed by Mellon Bank on December 30, 1993 with the Comptroller of the Currency." [Emphasis supplied.] Please catalogue and submit the nonpublic portion as well so that we can examine the entirety of the transaction.

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2. Please provide us with copies of the applications MBC has filed with the Board of Governors of the Federal Reserve System and with the Office of Thrift Supervision in connection with the proposed merger (your January 7 letter at pages 4-5). Please advise us whether there are any other regulatory approvals required or sought in connection with this transaction and provide us with copies of the related documentation.

3. Your Notice includes Dreyfus' 1992 annual report and its quarterly report for the quarter ended September 30, 1993 (Tab 4). No financial information on MBC and Mellon Bank was included. Please provide us with copies of the annual reports (including certified financial statements) and the most recent quarterly reports for Dreyfus and MBC and Mellon Bank for 1990 to the present. Please also submit copies of any financial projections that have been prepared with respect to the combined entities.

4.a. The Policy Statement on Mutual Funds (Tab 5) appears to adopt many but not all of the requirements of H.R. 3447, the Securities Regulatory Equality Act, a bill currently pending before the Committee on Energy and Commerce. Accordingly, please state with which provisions of H.R. 3447 do MBC and Dreyfus not plan to comply. Please identify by cross reference to specific sections of the bill and of the Policy Statement which provisions you have incorporated within your Policy Statement and which you have not, with an explanation of your noninclusion decisions.

b. Paragraph A. on p. 1 defines the term "Mellon Companies" as MBC's subsidiaries, including its bank subsidiaries. The term "Mellon-Advised Funds" is defined as mutual funds for which Mellon Companies provide advisory services. Because Dreyfus will become a subsidiary of Mellon Bank, rather than of MBC, it is unclear to what extent the Policy Statement will apply to Dreyfus and Dreyfus-advised funds. Please state with precision whether Dreyfus will be considered a Mellon Company and whether Dreyfus-advised funds will be considered Mellon-Advised Funds for purposes of the Policy Statement. If these definitions do not include Dreyfus and the Dreyfus-advised funds, please explain in detail what policies and procedures you will implement with respect to Dreyfus and Dreyfus-advised funds.

c. Paragraph J. on p. 5 states in relevant part that: "Mellon Company employees recommending and selling

mutual funds (Investment Services Employees) will be properly qualified and trained....No person will recommend or sell mutual fund shares in Mellon Bank branches unless he or she is registered with the National Association of Securities Dealers (NASD) as a broker or dealer, or as a representative of a broker or dealer, or as an investment adviser."

Although we appreciate the fact that Mellon Bank apparently intends to act through registered broker-dealers, please (i) state plainly whether Mellon Bank proprietary and Dreyfus funds will be sold only through Securities Exchange Act-registered broker-dealers who are licensed, qualified and in good standing with the NASD, and (ii) provide specific information regarding how such funds will be sold on bank premises. If it is not your intention to use registered broker-dealers exclusively for such sales, please outline and explain in detail any and all exceptions and how those entities and activities will be regulated. Please also explain the role, if any, of bank tellers and other non-securities personnel in selling funds. In the event that bank personnel are involved in such sales, how will they be compensated? Will such funds be sold in a physical location that is separated from the bank?

d. Paragraph D. on page 9 states: "If a Mellon Company is underwriting or placing any security, it will not sell such security to a Mellon-Advised Fund." Please specify the circumstances under which you expect Mellon Companies to become involved in underwriting activities and discuss the basis for such activity under the Glass-Steagall Act. Please state unequivocally whether (1) underwriting and (2) placing will be conducted only through Securities Exchange Act-registered broker-dealers who are licensed, qualified and in good standing with the NASD. If that is not your intention, please outline and explain in detail any and all exceptions and how such entities and activities will be regulated.

e. Paragraph B. on page 11 states: "<u>For so long as any Mellon Company is defined as a "broker"</u> under Section 3(a)(4) of the Securities Exchange Act of 1934..., such company will continue to be maintained as a separate company, registered with the SEC and subject to the 1934 Act. In addition, <u>for so long as any Mellon Company is defined as an "investment adviser"</u> under the Investment Advisers Act of 1940..., such company will continue to be maintained as a separate company, regis-

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tered with the SEC and subject to the Advisers Act." [Emphasis supplied.]

Please explain the meaning of the "for so long as..." language and advise the Subcommittee of any intentions to negatively affect such status and registration. If, in fact, the Mellon Company ceased to be registered as a broker-dealer and an investment adviser, under what regulatory scheme would you anticipate that its securities activities be regulated? Would that scheme provide customers comparable opportunities to pursue private remedies? Please be specific and document your analysis.

5. The Policy Statement states at paragraph N. on page 6 that: "Tellers at Mellon Banks will not receive referral fees <u>based on the success of sales of shares of mutual funds</u>." [Emphasis supplied.] Will tellers receive any other kind of referral fees? Please clarify. If there will be <u>no</u> referral fees, please so state. As a general matter, under what circumstances will bank tellers, customer service personnel, and similar personnel recommend mutual funds, either generally or as an alternative to certificates of deposit and money market deposit accounts? Please advise in detail how these referrals or recommendations will take place.

6. The Policy Statement states at VI. <u>Relationships Between Mellon Banks and Dreyfus</u> on page 9 that: "All transactions between Mellon Banks and Dreyfus and its subsidiaries will be subject to Sections 23A and 23B of the Federal Reserve Act without giving effect to the exemption set forth in subsection (b)(2)(A) of Section 23A."

   Since Sections 23A and 23B do not apply by their express terms to the subject entities, and since there is presumably no regulatory experience with the application of those provisions to banks vis-a-vis their subsidiaries, please explain in detail your understanding of how these restrictions will be implemented, examined for, and enforced.

7. What policies or procedures do you have in place to prevent MBC, Mellon Bank, and their subsidiaries and affiliates, from misusing material nonpublic information, and to prevent persons in possession of material nonpublic information from communicating it to others? Please explain how these policies or procedures operate to prevent the misuse or trans-

mission of material nonpublic information. Please discuss whether and how these policies and procedures will be applied to Dreyfus and Dreyfus-advised funds, particularly how they will prevent the transmission of material nonpublic information between Mellon Bank and Dreyfus. If you intend to implement separate policies or procedures for Dreyfus and Mellon Bank, please discuss them. In particular, please explain how your policies and procedures would prevent MBC, Mellon Bank, or any of their affiliates or subsidiaries from engaging in any abusive trading practices with respect to the Dreyfus-advised funds. Please explain why such policies and procedures are not included in the Policy Statement. Please furnish us with a written copy of those policies and procedures with your response to this letter.

8. The Compliance Overview (Tab 6) seems to say that MBC will be assuming responsibility for Dreyfus' compliance functions. What expertise does MBC have with respect to compliance with the federal securities laws? Please outline MBC's responsibilities and Dreyfus' responsibilities respectively under this construct. Please explain in detail how MBC and Mellon Bank will insulate themselves from liability under sections 20(a) and 15(b)(iv)(E) of the Exchange Act in view of this acknowledgement of Mellon's control relationship with regulated securities entities, and the impact of such liability on its capital position. Furthermore, what will be the liability of MBC and/or Mellon Bank and the deposit insurance fund for investor lawsuits against the registered broker-dealer?

The Compliance Overview also seems to say that after the merger Dreyfus will be subject to both banking laws and securities laws. How do you contemplate that conflicts between these laws will be resolved?

9. The Compliance Overview states at page 1 MBC's "commitment that Dreyfus will be operated as an independent entity for at least two years." What do you contemplate doing with Dreyfus after two years? Please be specific. In addition, do you contemplate any changes in personnel, especially key personnel, at Dreyfus and Dreyfus related entities?

10. Your December 30, 1993 transmittal letter to Deputy Comptroller Karen Wilson (the Wilson letter) notes that the proposed transaction "will substantially increase the capital of Mellon Bank," and the related capital discussions raise questions about consolidated capital for Dreyfus.

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a. Dreyfus Service Corporation (DSC) is registered with the SEC, the NASD and all fifty states as a broker-dealer, and, as such, is subject to necessary and appropriate financial responsibility standards including the applicable net capital requirements under Section 15(c)(3) of the Exchange Act. Please state whether the proposed capital consolidation will affect DSC's ability to remain in compliance with the applicable financial responsibility requirements under the federal securities laws. How can DSC's capital be counted towards the bank, and also for the securities firm? Can Mellon withdraw capital from Dreyfus to satisfy its banking needs, leaving DSC without enough regulatory capital? What safeguards does Mellon Bank intend to institute to protect and segregate the capital of DSC?

II. DSC currently serves as distributor of Dreyfus managed and/or administered funds pursuant to the terms of a distribution agreement with each fund. The Wilson letter states that "[u]pon the consummation of the transaction, the distribution function will be transferred to an independent third party and the company's activities will conform to those permissible under the Glass-Steagall Act."

a. Please outline and explain what activities will remain in DSC and what activities will be spun off to the third party distributor.

b. Concerns have been raised that third party distributors in general are mere shell companies that do very little and who usually subcontract out all activities, including advertising and marketing, to the bank. The small fees typically paid to such distributors bear out the lack of functions. Indeed, the Legal Memorandum (Tab 3) notes at page 36 that "[b]anks have increasingly sought to decrease the roles of third party distributors in the marketing of their proprietary mutual funds and commensurately to increase their own role and that of their broker-dealer affiliates." Other than putting its name on prospectuses, what do you contemplate that the third party distributor will do such that it will be deemed a "principal underwriter" pursuant to section 2(a)(29) of the Investment Company Act of 1940? Please provide specific information regarding the nature and extent of the distributors' role and any sub-contracts with Mellon entities. Has an agreement (in draft or final form) been reached with any third party distributors? If so, please provide a copy of any such agreement. How will third party distributors

be compensated? Also, will DSC continue to be registered as a broker-dealer?

12. The Legal Memorandum states at page 23 that "the Bank will not make any changes in the Policy Statement without prior notice to the Comptroller and the Federal Reserve Board, and the Bank will not make such change if either agency informs the Bank (within 30 days of the notification) that the change would result in a violation of the Glass-Steagall Act." The accompanying footnote states that "[i]n addition, the Bank will not make any change if it is advised (within 30 days of the notification) by the Comptroller that the change would be inconsistent with the Comptroller's approval of the proposed transaction."

These commitments provide no prior notice to the SEC, appropriate Congressional oversight committees, or the public, notwithstanding the potential import of such changes not only to safety and soundness but also to consumer protection and investor protection. Please explain your rationale for limiting prior notice to the Comptroller and the Federal Reserve.

Please explain your rationale for limiting the regulators' grounds for objection, that would block change to the Policy Statement, to that the change (1) "would result in a violation of the Glass-Steagall Act," or (2) "would be inconsistent with the Comptroller's approval of the proposed transaction." What changes would result in violation of the Glass-Steagall Act? To what extent does the scope and effectiveness of the second ground depend on the extent to which the Comptroller makes the Policy Statement's voluntary commitments formal conditions of approval? How much of the Policy Statement could you rescind without triggering regulatory objection under the standards on page 23?

13. The Wilson letter notes that the Dreyfus Security Savings Bank (DSSB) will become a non-bank subsidiary of MBC. What activities will be conducted in DSSB? In which states is DSSB currently authorized to branch? Please describe any plans to apply to branch into other states and any plans by MBC or Mellon to enter into joint ventures with DSSB in order to engage in full interstate branching.

14. Have MBC, Mellon Bank, or Dreyfus had any enforcement actions filed against them during the past 10 years, and have

Mr. Frank V. Cahouet
Mr. Howard Stein
Page 8

these entities entered into any agreements with their respective regulators concerning compliance-related matters? Please explain in detail and submit copies of related documents.

15. Please confirm that no documents relating to this transaction have been destroyed since the public announcement. If any documents have been destroyed, please provide a detailed description of the document(s) and the circumstances of the destruction.

16. Please provide us with copies of the following materials cited in the Legal Memorandum:

    (1) Mellon Bank Corporation, 79 Fed. Res. Bull. 626 (1993)
    (2) The Pearson Letter (January 13, 1993)
    (3) The Glidden Letter (January 14, 1993).

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

February 18, 1994

The Honorable John D. Dingell,
Chairman,
Subcommittee on Oversight and Investigations,
Committee on Energy and Commerce,
2323 Rayburn House Office Building,
Washington, D.C. 20515.

Re: Mellon Bank Corporation/The Dreyfus Corporation

Dear Chairman Dingell:

We are writing to respond to your letter to us, dated January 28, 1994, regarding the merger agreement between The Dreyfus Corporation ("Dreyfus") and Mellon Bank Corporation ("Mellon").

As an overview, our Policy Statement extends beyond existing law and regulation because we share the concerns you have expressed. Mellon and Dreyfus fully intend to abide by the spirit as well as the letter of the commitments made in the Policy Statement. Accordingly, we want to assure you that we are willing to have the commitments set forth in the Policy Statement be converted

into conditions of regulatory approval and thereby become enforceable requirements.

Our responses to your specific questions follow:

1. In accordance with discussions with your staff, we are separately submitting the nonpublic portion of the Notice filed by Mellon Bank with the Comptroller of the Currency on December 30, 1993. (Exhibit 1.) We respectfully request that the Subcommittee preserve the confidentiality of financial projections (provided in response to this Item 1 and in response to Item 3) and other business, competitive and trade secret information.*

2. Copies are enclosed of the applications and supplementary materials Mellon Bank Corporation ("MBC") filed with the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision. An application will be filed with the New York State Banking Department; if that application extends beyond the Federal Reserve application, a copy will be filed with the Subcommittee. Copies of any other applications filed with state

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* These financial projections and other information contain material that is highly sensitive, including from a competitive perspective.

authorities will be filed with the Subcommittee. (Exhibit 2.)

3. Copies are enclosed of the annual reports for MBC and Dreyfus for 1990, 1991 and 1992, Mellon's most recent quarterly report (third quarter of 1993), and earnings releases of MBC and Dreyfus for the full year 1993.* Mellon Bank, as a wholly-owned subsidiary of MBC, does not prepare annual reports, but we have enclosed its most recent financial statements filed with the Comptroller of the Currency. Financial projections prepared with respect to the combined entities, in addition to those provided in response to Item 1, are also enclosed. (Exhibit 3.)

4. Many of the specific questions in Item 4 are directed to the issue of customer protection. As an introductory comment, we would note that Sections 35 and 36 of the Investment Company Act, which are enforceable by the Securities and Exchange Commission ("SEC"), contain several directly relevant provisions. Section 35(a) makes it unlawful for any person in selling a security of a registered investment company to "represent or imply in any

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* Certain of this information was provided to the staff of the Committee on February 4, 1994.

manner whatsoever that such security or company has been guaranteed [or] sponsored by the United States or any agency or office thereof". Section 35(d) provides that it is unlawful for a registered investment company to adopt as part of the name of the company any words which the SEC finds to be deceptive or misleading. Section 36 generally authorizes the SEC to bring actions against investment advisors of a mutual fund for a breach of fiduciary duty. Specifically, an investment advisor and its affiliates are deemed to have a fiduciary duty with respect to the receipt of compensation or payments paid by the mutual fund.

4.a. As you have noted, Mellon's Policy Statement adopts many of the provisions of H.R. 3447. This result reflects Mellon's and Dreyfus' agreement with your statement that H.R. 3447 "provide[s] a strong and responsible framework for functional regulation to strengthen taxpayer and investor protections in the wake of recent decisions allowing banks to expand their securities activities". In those limited cases where the requirements of H.R. 3447 have not been adopted in full, Mellon and Dreyfus believe that adequate consumer and other protections are provided by alternative methods and/or that unilateral adoption of these

requirements prior to legislative enactment would place Mellon and Dreyfus at a serious competitive disadvantage.

The following chart compares (i) the relevant provisions of H.R. 3447 (as it relates to the Mellon-Dreyfus merger) and (ii) a summary of the related specific Policy Statement provisions, and sets forth an explanation for those provisions of H.R. 3447 that were not adopted.

H.R. 3447 Section	H.R. 3447 Requirement	Policy Statement
Section 104	Separate corporate entity.	Dreyfus will be maintained as a separate corporate entity and its present registered broker-dealer subsidiary, Dreyfus Service Corporation, will remain registered as a broker-dealer with the Securities and Exchange Commission. (This requirement was contemplated by the Notice and Policy Statement (Introduction, ¶ A and VIII) and will be added as a specific provision to the Policy Statement.)

H.R. 3447 Section	H.R. 3447 Requirement	Policy Statement
Section 111(a)	Custodial services.	If in the future Mellon were to serve as custodian for Dreyfus Funds pursuant to a decision by the Dreyfus Fund boards, it believes that it would clearly qualify for exemptive rules promulgated by the SEC. Mellon is one of the nation's major custodial banks and the Policy Statement contains a number of provisions that assure investor protection. We believe that Section 111(a) was not written as a flat prohibition, but is designed to permit custodial services as authorized by the SEC. We also note, in this regard, that the independent directors of the Dreyfus Funds must approve the election of and review the performance of the custodian. In addition, Rule 17f-2 under the Investment Company Act requires oversight by the independent auditors of a mutual fund whose assets are held in custody by a bank affiliated with the fund's adviser and Mellon has made a similar commitment. (V,B.)
Section 112(a)	Affiliated person.	Mellon and its affiliates will be "affiliated persons" of the Dreyfus Funds. (This requirement was contemplated by the Notice and will be added as a specific provision to the Policy Statement.)

H.R. 3447 Section	H.R. 3447 Requirement	Policy Statement
Section 112(b)	Purchases/Retire indebtedness.	No Dreyfus Fund will purchase securities in an underwriting if a Mellon Company employee acting in an investment advisory capacity has actual knowledge that the proceeds will be used to retire indebtedness to any Mellon bank subsidiary. (VII,A.)
Section 113	Controlling interest.	If any Mellon Company owns a controlling interest in a registered investment company, it will either pass through or proportionately vote the shares of the investment company as provided in H.R. 3447, to the extent consistent with its fiduciary duties and applicable law (including ERISA). (IV,C.)
Section 114	Borrowing from an affiliated bank.	No Dreyfus Fund shall borrow from a Mellon bank subsidiary except extensions of credit made in the ordinary course of providing custodial or cash management services to such a fund. (V,A.)

H.R. 3447 Section	H.R. 3447 Requirement	Policy Statement
		These short-term credit extensions are necessary because during the process of purchasing and selling millions of dollars of securities daily, it is not unusual for a custodial account for a fund to become overdrawn as a result of events outside the control of the fund or the custodian. For example, a sale of a security which was scheduled to settle on a particular date might not settle until the next day because of a delay in a wire transfer from a third party. The Dreyfus Funds make such borrowings from their present custodian. We assume that this is precisely the type of credit that Section 114 would permit the SEC to exempt. Such transactions are both short term and not volitional in nature, and are necessary to provide high quality custodial services. Any such extension of credit will be subject to Sections 23A and 23B of the Federal Reserve Act.
Section 115(a)	Interested person.	No Mellon employee will serve as a director of a Dreyfus Fund. (III,B.)
Section 115(b)	Bank holding company.	No Mellon Company will advise a mutual fund if a majority of the fund's directors are officers or directors or employees of any bank holding company or its affiliates. (III,D.)

H.R. 3447 Section	H.R. 3447 Requirement	Policy Statement
Section 116	Name confusion.	No Mellon Company will sell shares of a mutual fund or advise a mutual fund if such fund has a name, title or logo that is the same as the name, title or logo of a Mellon Bank or is so similar to such a name, title or logo as to be confusing to customers. (II,A.)

4.b. The term "Mellon Companies" as used in the Policy Statement includes Dreyfus. The term "Mellon-Advised Funds" includes the Dreyfus-advised mutual funds (the "Dreyfus Funds").

4.c; 5.* Mellon Bank proprietary funds and Dreyfus Funds sold by Mellon Company employees will be sold only by Securities Exchange Act-registered broker-dealers who are licensed, qualified and in good standing with the NASD.

Mutual fund shares are sold on Mellon Bank premises through registered representatives of InvestNet Corporation, MBC's broker-dealer subsidiary.** These

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* For convenience, the responses to Items 4.c and 5 have been combined.

** It should be noted that a small portion of sales of Dreyfus Funds will be made at or through Mellon Bank branches. The other sales will be made through Dreyfus' traditional distribution channels.

registered representatives also sell mutual fund shares through pre-arranged meetings at customers' homes and customers' offices and at other Mellon offices. In addition, registered representatives of Mellon Investment Products Company ("MIPC"), a registered broker-dealer subsidiary of Mellon Bank, sells mutual fund shares by telephone. InvestNet's registered representatives are primarily oriented towards serving the needs of branch-based customers; MIPC focuses on institutions and high net worth individuals (those with $500,000 or more in investable assets) and fixed-income investments.

The registered representatives of InvestNet Corporation have the responsibility for the sales efforts for mutual fund shares in Mellon Bank branches. These registered representatives meet with customers by appointment to perform an asset allocation analysis for the customer based upon the customer's financial position, tax status, investment objectives and risk tolerance. The representatives also use these meetings to educate customers about the investment products being offered. These meetings typically occupy at least an hour's time.

At the end of a customer meeting, the registered representative will recommend suitable investments to the customer. If the representative's analysis shows that the customer is best served by deposit products, the customer is referred back to the branch. If the representative believes that the customer would be best served by an annuity, the customer is referred to an independent insurance agency for this purpose. If the customer's investment profile indicates that mutual funds are a suitable investment, the representative will recommend specific mutual funds to the customer. Once a registered representative makes recommendations to a customer a subsequent meeting is frequently arranged so that the customer can think over the recommendations before acting. At the first meeting the customer receives written disclosures that mutual funds are not FDIC-insured, are not bank obligations or bank-guaranteed and are subject to investment risk, including the possible loss of principal, and that Mellon proprietary funds pay to receive certain services from Mellon entities. The customer signs a copy of these disclosures acknowledging their receipt. (Exhibit 4.)

The role of non-securities personnel (tellers and branch platform staff) in the sale of mutual fund shares is limited and specifically delineated. Specifically, any such personnel making referrals relating to mutual funds must disclose that mutual funds are not insured by the FDIC or any other government agency, are not bank accounts, are not guaranteed by or obligations of Mellon Bank or any other bank, and that mutual funds involve a certain amount of risk, including the possible loss of principal. They make these disclosures by reading customers the text of a card. (Exhibit 5.)

The role of bank tellers is minimal. Tellers can only refer potential customers for investment products to branch platform staff (customer service representatives and branch management). Tellers are strictly prohibited from providing advice or recommendations regarding, or effectuating sales of, mutual funds.

Branch platform staff do not provide investment advice or recommendations regarding mutual funds, and provide only general product information such as how shares of the mutual funds may be purchased and the difference between mutual funds and bank deposits. Branch platform

staff are trained to classify customers into one of four categories, by their investment orientation and needs, and generally to proceed as follows:

(1) Deposit-oriented customers to whom FDIC insurance is important are referred back to tellers.

(2) Persons seeking investment advice (including advice on mutual funds) or who wish to purchase a mutual fund other than a Mellon proprietary fund will be referred to InvestNet. The role of InvestNet personnel, who are registered broker-dealers, was discussed above.

(3) Persons who wish to receive securities trading services without investment advice will be given an application to establish brokerage accounts with InvestNet. When a customer makes such an application, he or she signs the same form that a customer buying mutual funds through a registered representative would have signed. (See Exhibit 4.) Customers establishing InvestNet accounts through bank branches (or otherwise) buy and sell mutual funds and other securities by calling InvestNet directly.

(4) Persons who seek to purchase shares in Mellon proprietary funds will receive applications to buy these funds from broker-dealers selling the funds. Customers

receiving these applications sign a disclosure form advising them that the funds are not FDIC-insured, are not bank obligations or bank-guaranteed, are subject to investment risk including the possible loss of principal, and pay to receive certain services from Mellon entities. (Exhibit 6.)

The training materials included as Exhibit 7 demonstrate this approach.

It may be helpful, at this point, to review how and when Mellon customers receive disclosures of the differences between bank deposits and mutual funds when they buy a mutual fund through a Mellon Bank branch. First, Mellon Bank branches have graphic disclosure signs prominently displayed at multiple locations within each branch. (Exhibit 8.) Second, any customer discussing uninsured investment products with a branch employee is shown and read a disclosure card. (See Exhibit 5.) Third, customers establishing brokerage accounts with InvestNet or receiving applications to purchase proprietary funds directly from their distributor sign a disclosure form acknowledging receipt of disclosures. (See Exhibit 4.) Fourth, the Funds' prospectuses themselves contain disclosures. (Exhibit 9.) Finally, any customer meeting

with a registered representative receives oral disclosures from the representative and is encouraged to discuss them with the representative. Thus, Mellon customers receive disclosures covering the critical differences between mutual funds and bank deposits on at least four and as many as five occasions.

Mellon's concern with disclosures extends beyond legal and regulatory requirements. Mellon wants its customers to understand the investment products that they buy through the bank. This is not just due to Mellon's concern about doing the right thing for its customers; it is also good business. Mellon believes that fostering customer understanding of its products is a key factor in preserving and enriching valuable long-term customer relationships.

Mellon does not pay branch personnel on a per-item basis for any financial service or product which is referred or sold. This procedure is in contrast to a number of banks which pay a specific fee to branch personnel for referrals to an investment sales area.

Rather, Mellon employs an incentive compensation system for branch personnel that is designed to reward:

- A wide range of sales and service results consistent with its relationship banking philosophy.
- A team orientation (among tellers, customer service representatives and branch management) to sales and service.

Features of this compensation are:

- On average, salary comprises over 95% of tellers' and customer service representatives' take home compensation. Incentives comprise less than 5%.
- Quarterly branch (team) level incentive pools are determined by formula, with each branch manager setting and paying the individual incentive awards of branch personnel from the pool for that branch.
- The amount of a branch's incentive payment pool is determined by the branch's performance in many different categories, including Total Quality (customer service) and Management Control (including compliance). In fact, compliance failures can remove a branch from the pool entirely.

- Individual payments from the branch incentive pool may be based on a wide variety of factors including the degree to which an employee has met certain activity goals set weekly by his or her manager. For customer service representatives, one of these activity goals may be referrals to InvestNet registered representatives. However, the system does not directly result in the compensation of any individual for any one activity.
- Tellers' activity goals cannot include sales of investment products. However, teller referrals to customer service representatives -- who are trained to channel customers to the appropriate channel based on customers' needs and preferences -- can be included.

As mentioned above, mutual fund sales do occur on branch premises. In fact, the structure of modern bank branches, such as branches in grocery stores, puts such a premium on space that it would be wholly impractical to dedicate a fixed area in these branches to functions that would only occasionally be performed there. However, no sales of investment products are made, and no investment

advice is given, at any teller line. Although the sales area is not physically separated from the remainder of the branch, registered representatives of InvestNet (the only persons selling mutual fund shares in the branches) use signs that graphically show that mutual funds are not FDIC-insured, are not bank deposits, are not guaranteed by Mellon Bank or any other bank and are subject to investment risks, including the possible loss of principal. (See Exhibit 8.) These representatives also make these same disclosures to customers orally and, if a customer buys shares of a fund, require the customer to sign a disclosure that spells these points out in even more detail and discloses that Mellon proprietary funds pay to receive services from Mellon entities. (See Exhibit 4.) If after hearing these disclosures a customer opts for insured bank products, the representative refers the customer back to a bank employee.

4.d. Mellon engages in underwriting securities only to the limited extent explicitly permitted by the Glass-Steagall Act for national banks. See 12 U.S.C. § 24 (seventh) and 12 C.F.R. Part 1. The only securities eligible for underwriting by a national bank are securities issued or guaranteed by the federal government or its

agencies, general obligation (but not revenue) obligations of states and their political subdivisions and certain other governmental or quasi-governmental securities specified in the Glass-Steagall Act.

At this time, Mellon conducts these limited underwriting and securities placement activities within Mellon Bank, N.A., as is permitted by the Glass-Steagall Act. These activities are subject to regulation and examination by the Comptroller of the Currency and the Federal Reserve Board, as well as by the Municipal Securities Rulemaking Board. Because Mellon is a bank, its underwriting and placing activities are not subject to the Securities Exchange Act of 1934 (see Section 3(a)(4)), and employees involved in these activities are not registered under the Securities Exchange Act of 1934 or licensed by the NASD.

4.e. The phrases "for so long as any Mellon Company is defined as a ". . ." broker" or "investment advisor" was not intended to suggest that Mellon has any plans to change the status or registration of any such subsidiary. There are no such plans. The phrases were only

designed to deal with possibility (even if remote) that the statutory definitions would be changed.

5. See Item 4.c.

6. Mellon anticipates that the application of Sections 23A and 23B of the Federal Reserve Act to transactions between Mellon Bank and Dreyfus, as provided for in the Policy Statement, would be incorporated as a condition of any approval of the merger (if granted) by the Comptroller. Accordingly, the Comptroller would examine for, and enforce compliance with, these two Sections to the same extent as the Comptroller examines for and enforces compliance with these two Sections in the context of national bank transactions with affiliates other than operating subsidiaries.

Mellon has extensive experience with implementation of Sections 23A and 23B between its bank subsidiaries and most of their affiliates. Mellon will adopt the same implementation processes and procedures that it presently uses for transactions between Mellon Bank and Dreyfus.

We also note that the Federal Reserve has the authority, under Section 23A(b)(1)(E), to override the

subsection (b)(2)(A) exemption and apply Sections 23A and 23B to transactions between Mellon Bank and Dreyfus.

7. Mellon has adopted extensive policies and procedures to prevent the misuse of material non-public information by MBC, Mellon Bank and their subsidiaries and affiliates. These policies and procedures are designed, among other things, to limit access to material non-public information.

A copy of MBC's Confidential Information and Securities Trading Policy (the "MBC Policy") is enclosed. (Exhibit 10.) Beginning at page 5, Mellon's policies and procedures for preventing the misuse of material nonpublic information are described. Among these policies and procedures are the following:

- Employees in "Investment Functions" (this would include Dreyfus) may not have access to commercial credit or other "Potential Insider Function" files that might contain material nonpublic information.
- All files containing material nonpublic information must be marked as "Confidential" and, if feasible, segregated from nonconfidential files.

-- Employees in Investment Functions may not have access to personal computer or word processing files of employees in Potential Insider Functions.

-- Associates in Investment Functions may not attend meetings between customers and associates in Potential Insider Functions unless appropriate steps have been taken to ensure that material nonpublic information will not be disclosed or discussed.

Mellon believes that its policies and procedures have been successful in preventing misuse of nonpublic information.

Dreyfus also has extensive policies and procedures designed to prevent the misuse of material nonpublic information, which are codified in a Code of Ethics (the "Dreyfus Code"). (Exhibit 11.) Use of material nonpublic information in the possession of Mellon Bank by any Dreyfus or Dreyfus Fund would be strictly prohibited by both the Mellon Policy and the Dreyfus Code.

The MBC Policy and Dreyfus Code are also designed to prevent abusive trading practices such as "front running", i.e., an employee's buying and selling securities

for his or her own account on the basis of knowledge of Mellon's trading positions or plans.

The MBC Policy and Dreyfus Code will be incorporated by reference into the Policy Statement. Section II,O of the Policy Statement already provides that Mellon Bank will not share confidential customer information with any Mellon Company providing investment services (such as Dreyfus) other than (i) pursuant to the customer's consent or (ii) information of a type that the Mellon Company could receive in a credit bureau or similar report.

8. Mellon has extensive experience and expertise with respect to compliance with the federal securities laws. First, as advisers or third party administrators to over 300 portfolios of investment companies registered under the Investment Company Act of 1940, with over $80.0 billion in assets, Mellon has considerable experience in this directly relevant area of the federal securities laws. Second, MBC is publicly-held and thus subject to the full requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "1934 Act"). Since January 1, 1990, MBC and its non-bank subsidiaries have issued securities pursuant to 17 registration statements with the SEC, as well

as filing dozens of reports under the 1934 Act. Third, Mellon has two subsidiaries registered as broker-dealers under the 1934 Act, InvestNet Corporation and Mellon Investment Products Corporation, which must comply with all the terms of that statute. Fourth, Mellon has 13 subsidiaries registered as investment advisers under the Investment Advisers Act of 1940.

Each of Mellon and Dreyfus has extensive compliance functions in place for their respective operations. As described in the Compliance Overview accompanying Mellon's Notice to the Comptroller, there is substantial similarity in the nature of these compliance functions at the two organizations. After the merger, each organization would maintain its present compliance structure, but (1) there would be institutionalized communications across all levels of the respective organizations and (2) as required by the Comptroller, Mellon's compliance personnel would assume accountability for and oversight of the activities of Dreyfus as a subsidiary of Mellon Bank. This latter approach would not, however, relieve Dreyfus of accountability for compliance or reduce its efforts.

After the merger, Dreyfus would be subject not only to securities laws but also to banking laws to the extent that a Dreyfus activity is the subject of a banking law or regulation. Mellon is in favor of "functional regulation" by the regulatory bodies which oversee the financial industry, and hopes that such an approach would not result in conflicting laws or regulations. To the extent, however, that there is such a conflict, Mellon would resolve it by following the more stringent applicable law or regulation.

Dreyfus and its broker-dealer subsidiary, Dreyfus Service Corporation ("DSC"), will be separately incorporated, well capitalized entities with substantial existing and ongoing operations. Accordingly, based on relevant legal principles neither MBC nor Mellon Bank should have liability for investor lawsuits against Dreyfus or DSC, and there can be no valid claim against the deposit insurance fund. We note, in this regard, that there have been no lawsuits brought against Dreyfus or DSC alleging investment mismanagement.

Mellon believes that neither Mellon Bank nor MBC will have liability under Section 20(a) of the 1934 Act in

view of the policies and procedures (including the Policy Statement) that it has adopted. Section 20(a) does not impose liability on a controlling person if that person acted in good faith and did not induce the act or acts constituting the violation or cause of action. Section 15(b)(4)(E) imposes liability only upon a registered broker-dealer, and neither MBC nor Mellon Bank is a registered broker-dealer. Even if, however, the terms of this Section applied, Mellon believes that neither MBC nor Mellon Bank would have liability because its procedures would qualify for the exemption in Section 15(b)(4)(E)(i) and (ii).

9. As provided in their merger agreement, Mellon and Dreyfus have agreed that for at least two years following the effective date of the merger Dreyfus will continue to be headquartered in New York City; Dreyfus will continue to operate as a separate corporation under the Dreyfus name; and Messrs. Stein and DiMartino of Dreyfus will continue to be Chief Executive Officer and Chief Operating Officer of Dreyfus, respectively. Messrs. Cahouet and Smith of Mellon will be added to the separate board of directors of Dreyfus, and an executive committee of the

board will be created consisting of Messrs. Stein and Dimartino from Dreyfus and Messrs. Cahouet and Smith from Mellon. Mellon and Dreyfus believe that it is in the best interests of the shareholders of the Dreyfus Funds that there be stability and continuity in the management of those funds. Moreover, it should be noted that one of the chief reasons why Mellon desired to merge with Dreyfus was the high quality of Dreyfus management. There are no present plans to change the key personnel of Dreyfus after the two year period referred to above.

10. The capital consolidation of Dreyfus Service Corporation ("DSC") with Mellon Bank for bank regulatory purposes will not affect the ability of Dreyfus Service Corporation to remain in compliance with all financial responsibility standards, including the net capital requirements of Section 15(c)(3) of the 1934 Act. The consolidation does not diminish the capital of DSC.

DSC's capital is, in fact, far in excess of that necessary for all its capital requirements, and Mellon will amend the Policy Statement to provide that it will not withdraw capital from DSC if such withdrawal would jeopardize DSC's ability to maintain its capital compliance. In

order to assure against any violation of this commitment, Mellon will confirm with a senior financial officer of DSC that any withdrawal would not result in the violation of any capital requirement.

DSC's capital can be counted towards both bank and securities capital compliance because the capital is in the securities company and represents an investment by the bank in the securities company.

11.a. DSC will be one of numerous broker-dealers that will enter into agreements with the independent third party distributor for the Dreyfus Funds relating to agency sales of Dreyfus Fund shares. DSC will also provide various administrative services to the Dreyfus Funds.

The following activities of DSC will be spun off to and performed by the third party distributor:

- Entering into distributor agreements with the Dreyfus Funds.
- Being named as the "distributor" in all fund prospectuses and sales literature.
- Confirming to the investor or to a broker-dealer all sales of Dreyfus funds shares with a

confirmation complying with Rule 10b-10 under the 1940 Act.

- Providing the required seed capital for any new funds.
- Entering into agreements with broker-dealers selling the Dreyfus funds.
- Collecting front-end sales charges from broker-dealers or investors.
- Advancing commissions to broker-dealers.
- Receiving and transmitting that portion of 12b-1 payments that will be paid to broker-dealers as sales and maintenance commissions, and entering into 12b-1 agreements with broker-dealers, banks and others as contemplated by Rule 12b-1.
- Collecting back-end sales charges from redeeming shareholders.
- Paying the costs of printing and distributing prospectuses to potential investors.

In addition, the third party distributor will provide various administrative services, which will be negotiated with the third party distributor.

11.b. No agreement in draft or final form has been reached with a third party distributor. It is presently contemplated that the third party distributor will be compensated as follows: (i) the underwriter's spread on dealer sales and the total spread on direct investor sales; (ii) back-end sales charges paid by redeeming shareholders; (iii) its portion, if any, of Rule 12b-1 distribution payments and maintenance fees or of any servicing payments due to the distributor; and (iv) payments pursuant to an administration agreement with Dreyfus for the various administrative services provided. It is not contemplated that the third party distributor will subcontract any services to any Mellon entity.

DSC will continue to be registered as a broker-dealer because it will serve as a broker (but not as an underwriter).

Section 2(a)(29) of the 1940 Act defines a principal underwriter in terms of any of three different functions: (i) an underwriter which purchases as principal a mutual fund's shares for distribution; (ii) an agent for a mutual fund which sells the fund's securities to dealers; or (iii) an agent for a mutual fund which sells the fund's

securities to the public. The third party distributor will perform the second and third functions and may perform the first.

12. Mellon Bank has assumed that compliance with the Policy Statement would be a formal condition of the Comptroller's approval of the merger. For this reason, prior notice to the Comptroller of any change in the Policy Statement would be required in order to assure that Mellon remained in compliance with the terms of the approval order.

Although Mellon believes there is no requirement that it provide notice to the Federal Reserve Board regarding a change in the Policy Statement, in view of the concern expressed by you and others regarding compliance with the Glass-Steagall Act, Mellon is providing such notice on a voluntary basis.

For the same basic reasons, the regulators' grounds for objections are explicitly limited to a violation of an approval order or the Glass-Steagall Act. Of course, the regulators could object on any other grounds if they thought such an objection was appropriate.

Because the SEC will not be approving the Policy Statement or the merger (and does not enforce the Glass-

Steagall Act), Mellon does not believe that it is necessary or appropriate to provide prior notice to the SEC. Mellon is not aware of any procedure or precedent for prior notice to Congress, and it believes that Congressional oversight of the two banking agencies should provide Congress with a review process.

Mellon believes that if it or Dreyfus performed any significant part of the third party distributor's functions it would be in violation of the Glass-Steagall Act as administered and interpreted. Mellon simply does not know what elements of the Policy Statement could be rescinded without regulatory objection.

13. Dreyfus Security Savings Bank's activities will principally consist of taking deposits and making mortgage loans and certain other secured consumer loans. DSSB has a branch in San Francisco and has received approval from the OTS for 12 additional branches: New York City (4), Uniondale, New York, Beverly Hills, California, White Plains, New York, Chicago, Denver, Los Angeles, Boston, Atlanta and Boca Raton, Florida. All such branches will be in compliance with the Home Owners Loan Act and the rules and regulations of the Office of Thrift Supervision. Mellon

and Dreyfus have no plans for MBC or any Mellon bank subsidiary to enter into joint ventures with DSSB in order to engage in full interstate branching.

14. Enclosed as Exhibit 12 is a list of the requested regulatory actions and relevant exhibits.

15. Each of Mellon and Dreyfus has followed its normal policies and procedures regarding retention of documents throughout this transaction. As a matter of practice, neither organization normally retains drafts of documents, but no final documents have been destroyed.

16. Copies of the requested materials are enclosed. (Exhibit 13.)

We trust that the foregoing has been responsive to your request. If we can be of further assistance, please do not hesitate to contact either of us.

Very truly yours,

Frank V. Cahouet
Mellon Bank Corporation

Howard Stein
The Dreyfus Corporation

cc: The Honorable Dan Schaefer

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 21, 1994

Mr. Frank V. Cahouet
Chairman
Mellon Bank Corporation
One Mellon Bank
Pittsburgh, Pennsylvania 15258

Mr. Howard Stein
Chairman
The Dreyfus Corporation
200 Park Avenue
New York, New York 10166

Dear Messrs. Cahouet and Stein:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation whereby Dreyfus will be acquired by Mellon Bank, N.A. as a separate operating subsidiary.

In connection with your testimony at the Subcommittee hearing on March 3, 1994, this is to request that you provide for inclusion in the record the following responses, information and documents by the close of business on Thursday, March 31, 1994.

1. As requested (Tr. p. 171), please submit a copy of the customer disclosure form described by Mr. McGuinn.

2. As requested (Tr. p. 183), please submit samples of the brochures described by Mr. DiMartino.

3. Dreyfus sells mutual funds through cold calling over the phone, and through the distribution of advertisements and brochures. What specific disclosures will be incorporated into these marketing techniques to ensure that potential

customers will not infer that Mellon Bank in anyway either outright insures or partially protects against the loss of principal through such investments?

4. Does Mellon Bank plan to provide Dreyfus with customer information of any kind, such as dates when CD's are maturing or lists of customers with sizeable accounts? If so, what specifically? Also, please detail for the Subcommittee the specific limitations Mellon Bank and Dreyfus plan to impose or observe on the sharing of customer information? If <u>any</u> information is to be cross-exchanged, please detail the specific <u>objective(s)</u> for each <u>type</u> of information. (Do this for both Mellon Bank and Dreyfus individually.)

5. It is very likely that there will be at least <u>some</u> confusion regarding the uninsured nature of some of the products sold through Mellon Bank. As was indicated by the American Association of Retired Persons (AARP) at the recent Subcommittee hearing, some surveys are finding that between 80 and 90 percent of all customers purchasing mutual funds through banks believe such funds are insured by the U.S. Government. Clearly, if the objective is to deliver adequate consumer protection, that level of confusion is unacceptable. First, what level of confusion does Mellon Bank believe is acceptable for its own customers? (Please provide more than a verbal explanation here and include some <u>quantitative</u> measure outlining the <u>maximum</u> threshold of confusion Mellon Bank is willing to accept regarding its own customers.) Second, if any governmental body performing oversight or testing of bank-mutual fund operations (such as the OCC, for example) determines that Mellon's rate of customer confusion exceeds this determined maximum limit, would Mellon Bank temporarily suspend the sale of mutual funds until the situation is corrected? If so, how would this be done? If Mellon Bank is unwilling to temporarily suspend the sale of its mutual fund program until the confusion can be remedied, then please explain (a) the basis for such a decision, and (b) how refusal to suspend is ultimately in the best interest of Mellon's customers?

If you have any questions about this request, please contact Bruce F. Chafin or Christopher Knauer of the Subcommittee staff at (202) 225-4441. Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

March 31, 1994

Hon. John D. Dingell,
Chairman,
Subcommittee on Oversight and Investigations,
House Committee on Energy and Commerce,
Washington, D.C.

Dear Chairman Dingell:

We are writing in response to the questions and requests in your letter of March 21, 1994.

1. Attached as Annex A is a copy of the customer disclosure form described by Mr. McGuinn.

2. Attached as Annex B are samples of the brochures described by Mr. DiMartino.

3. Mellon and Dreyfus are committed to avoiding any inference, in Dreyfus' telemarketing, advertisements and brochures for Dreyfus funds, that Mellon Bank in any way either outright insures or partially protects against the loss of principal in such investments. In particular, the Dreyfus funds will not be linked to Mellon Bank in such telemarketing, advertisements and brochures. In addition, Dreyfus' written sales program will contain specific disclaimers to the effect that the mutual fund shares are not obligations of or guaranteed by a bank.

4. As provided in the Policy Statement, at II.0., confidential customer information will not be shared with any Mellon Company providing investment services (such as Dreyfus) other than pursuant to the customer's consent and information of the type that the Mellon Company could receive in a credit bureau or similar report. As we indicated at the Hearing, Mellon as well as Dreyfus have products that add value and that customers would be interested in considering purchasing. Furthermore, a real consumer benefit is one-stop shopping which requires that customers are aware of all the products and services that would be available to them. At the same time, Mellon recognizes and respects its customers' need for privacy, and we believe that Mellon has dealt effectively with that issue for many years.

With respect to information regarding shareholders of the Dreyfus funds, we note that the SEC has held that shareholders lists are property of the fund and may only be used with the specific approval of the independent directors of the fund. The SEC requires that directors consider specific criteria before they would permit their fund's shareholder list to be used for solicitation for purchase of another financial product.

5. As Mr. Cahouet testified at the Hearing, there is no such thing for Mellon or Dreyfus as an acceptable level of customer confusion regarding the non-insured nature of mutual funds. We share your concern that several recent surveys have indicated that purchasers of mutual funds are confused as to the non-insured nature of the funds. The numerous procedures and policies that Mellon has put into place, and the additional procedures and policies that Mellon is now implementing, are designed to eliminate that confusion.* Moreover, as we indicated during the Hearing, Mellon attempts to assure that these policies and procedures are working effectively. This process involves "mystery shoppers", testers and inquiry of customers.

It is in our own best interest to make sure that our customers understand what they are buying because not only are we concerned about doing the right things for our customers, but because it makes good business sense. It has been our philosophy that fostering customer understanding of our products is a key factor in ensuring and enriching a long term customer relationship.

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* These policies and procedures are described in detail in our written submission of February 18, 1994 to the Subcommittee.

Nonetheless, the SEC's own survey demonstrates that customer confusion is not solely, and perhaps not even primarily, a product of bank sales of mutual funds. That survey revealed that there was a higher level of confusion on the FDIC insurance issue for sales at brokerage houses than for sales at banks. Accordingly, it may well be that no individual bank's or brokerage house's efforts, no matter how extensive or detailed, can totally eradicate customer confusion.

As mentioned, Mellon and Dreyfus do not regard any level of customer confusion on the insurance issue as acceptable. However, we do not believe that a suspension of sales would be an appropriate response. Indeed, it would harm the vast majority of Mellon Bank customers who would not be confused, but would be denied access to the Dreyfus funds. It could also harm existing fund shareholders because Dreyfus could be required to liquidate assets at potentially unfavorable prices to deal with redemptions. Indeed, we question whether suspension of sales would even help potential customers who are confused. If they cannot purchase fund shares from Mellon, they will purchase shares of another (or the same) fund elsewhere; and if they would be confused on the insurance issue despite Mellon's extensive disclosures and other procedures, they will almost

certainly be confused when they purchase the shares from another financial institution.

Finally, as stated before, we believe the best way to address customer confusion is through an aggressive disclosure program such as we presented at the Hearing.

Very truly yours,

Frank V. Cahouet
Mellon Bank Corporation

Howard Stein
The Dreyfus Corporation

cc: The Honorable Dan Schaefer

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Disclosure and Information-Sharing Agreement

InvestNet®

Investments sold by InvestNet (including The Laurel Funds and The Boston Company Family of Funds):

- **ARE NOT INSURED BY THE FDIC OR BY ANY OTHER GOVERNMENT AGENCY;**
- **Are not obligations of the FDIC or any other government agency;**
- **Are not deposits or other obligations of Mellon Bank or any other bank;**
- **Are not endorsed or guaranteed by Mellon Bank or any other bank;**
- **Are subject to investment risks, including possible loss of the principal amount invested;**
- **May fluctuate in value, so that when they are sold they may be worth more or less than when they were purchased.**

An investment's past performance should not be considered an indication of its future results.

InvestNet is a brokerage subsidiary of Mellon Bank Corporation. It is a member of NASD. InvestNet is not a bank and is separate from any affiliated bank. InvestNet is solely responsible for its contractual obligations.

The Laurel Funds pay Mellon Bank, N.A. or its affiliate to be their investment adviser. Mellon Bank, N.A. or an affiliate may be paid for performing other services for The Laurel Funds, such as custodian, transfer agent or fund accountant services. The Laurel Funds are distributed by a third party funds distributor that is not an affiliate of Mellon Bank.

The Boston Company Family of Funds pays Boston Safe Deposit and Trust Company or an affiliate of Boston Safe to be its investment adviser and custodian. The Boston Company Family of Funds is distributed by a third party funds distributor that is not an affiliate of Boston Safe Deposit and Trust Company.

Mellon companies are paid to provide mutual fund services to many other mutual funds. A mutual fund's prospectus discloses the companies providing such services to it, and the fees it pays for those services.

Mutual funds purchased through InvestNet (including shares of The Laurel Funds and the Boston Company Family of Funds) may be subject to fees and expenses when they are purchased, during the time that they are held or when they are sold. These fees and expenses are described in detail in each fund's prospectus. Sales charges may make some mutual funds inappropriate as a short term investment.

You should read the prospectus of any mutual fund before you invest in it.

InvestNet charges fees and commissions for its services, as described in InvestNet's Fee Schedule and Commission Schedule.

You authorize InvestNet, its affiliates (including the Mellon Banks and Boston Safe Deposit and Trust Company), The Laurel Funds and The Boston Company Family of Funds to share information about you and your accounts with any of these organizations. This includes all information that these organizations have or may obtain about you or your account relationships.

I/We have read these disclosures and understand them. I/We acknowledge receipt of a copy of these disclosures.

Signature X ______________________ Date __________

Signature X ______________________ Date __________

Note: Please sign, date and submit this form, along with your completed new account application, to InvestNet.

ONE HUNDRED THIRD CONGRESS

JOHN D. DINGELL, MICHIGAN, CHAIRMAN

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U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

February 14, 1994

The Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Greenspan:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

As a starting point, we have reviewed the copy of the Notice of the transaction and supporting documentation that was delivered by MBC to the Committee on Energy and Commerce on January 3, 1994, as well as the responses of MBC and Dreyfus, the Securities and Exchange Commission (SEC), and the Comptroller of the Currency (OCC), responding to the December 10, 1993 Gonzalez-Dingell letter. In order to assist the Subcommittee in its investigation and in preparation for upcoming hearings, your cooperation is requested in providing the following responses by the close of business on Friday, February 25, 1994.

1. The Subcommittee understands that part of the Mellon-Dreyfus proposed merger is subject to approval by the Federal Reserve Board (Board).

   a. Please explain in detail any applications that the Board is considering as part of the proposed transaction. Does the Board plan to obtain public comment prior to making its decision?

   b. Please discuss the Board's views on the advisability of banks engaging directly in the mutual fund business. Are there adequate bank controls and compliance

The Honorable Alan Greenspan
Page 2

systems? What types of firewalls or other protections are needed? Please advise the Subcommittee whether there are alternative approaches to structuring the Mellon-Dreyfus merger that would better address the (1) safety and soundness and (2) investor protection concerns raised by the proposed merger.

2. The OCC letter of January 12, 1994 states (p. 2, fn. 2) that "[t]he OCC will carefully consider the consequences of the structure of the proposed transaction for the capital position of both Mellon and Dreyfus." As you know, MBC has stated that "a principal reason" for structuring the transaction along the lines proposed is so that Mellon Bank can consolidate Dreyfus' capital with its own capital base.

   Dreyfus Service Corporation (DSC) is registered with the SEC, the NASD and all fifty states as a broker-dealer, and as such, is subject to necessary and appropriate financial responsibility standards including the applicable net capital requirements under section 15(c)(3) of the Exchange Act. We are concerned that the capital of the Dreyfus broker-dealer subsidiary will be consolidated with that of Mellon Bank, potentially harming the subsidiary's compliance with its financial responsibility requirements under the federal securities laws.

   Both the Board (in your Section 20 orders) and the Federal Deposit Insurance Corporation (FDIC) (in 12 C.F.R. section 337.4(b)(3)) have adopted measures to ensure the adequate capitalization of securities subsidiaries and prevent the double-leveraging of securities subsidiaries' capital. Both provide that the parent entity's investment in a securities subsidiary will not be counted toward satisfaction of the parent entity's capital requirement. Please explain the rationale for your position. What would be the consequences of the failure of the OCC to make similar provision for ensuring the separate capitalization of national bank subsidiaries? What capital conditions should the OCC require in connection with the proposed transaction?

3. Please comment on the OCC's statement (p. 6) that "[b]ecause establishment of operating subsidiaries is part of the business of banking, it is not proscribed by 12 U.S.C. section 24(7) provisions on purchasing corporate stock." Please explain how you distinguish between "incidental" activities and those "closely related to banking," which are subject to the requirements of the Bank Holding Company Act.

   a. Please provide the Subcommittee with a list or chart comparing those activities that the OCC has deemed

"incidental to banking" to those activities that the Fed has deemed "closely related to banking" for the purpose of the Bank Holding Company Act. If many activities overlap (as the Subcommittee believes to be the case), what is the purpose for two different regulatory schemes?

b. Please explain the nature and extent of the Board's authority under Section 4 of the Bank Holding Company Act, and whether this provision provides the Board with the authority to regulate national and state-chartered bank subsidiaries in addition to bank holding companies. Does the existing bifurcated regulatory scheme (with the OCC as primary regulatory of bank subsidiaries) undermine consolidated bank holding company regulation?

4. Mellon's Legal Memorandum notes at page 36 that "[b]anks have increasingly sought to decrease the roles of third party distributors in the marketing of their proprietary mutual funds and commensurately to increase their own role and that of their broker-dealer affiliates." Concerns have been raised that third party distributors in general are often mere shell companies that do very little and that usually subcontract out all activities, including advertising and marketing, to the bank. The small fees typically paid to such distributors bear out the lack of functions.

a. Please explain why an entity that does not perform the functions of marketing, selling, or advertising a mutual fund, as would seem to be the case in the Mellon/Dreyfus situation, should nonetheless be considered to be the "distributor" of such fund for Glass-Steagall purposes. What is your understanding of the role contemplated for Dreyfus Service Corporation or any other affiliate of Mellon in the process of marketing shares of the Dreyfus funds? How does that role satisfy the applicable statutory language and its intent? What is the appropriate role of a distributor for Glass-Steagall purposes?

b. In April 1993, the Board-approved Mellon's purchase of The Boston Company (TBC), a firm that, among other things, provides investment advice and administrative services to mutual funds, and authorized Mellon to continue providing such services through TBC. However, as part of the approval, Mellon pledged to terminate TBC's role as a sponsor of mutual funds, and represented that no Mellon entity would be involved in the distribution of shares of any mutual fund.

The Honorable Alan Greenspan
Page 4

Nonetheless, the Mellon-Dreyfus application to the OCC would appear to permit Dreyfus entities (to be acquired by Mellon) to continue to be involved in wide-scale distribution of mutual funds. Is the Mellon-Dreyfus application consistent with the TBC approval? Please comment on the different regulatory approaches taken by the Board and the OCC in these similar circumstances, and explain why the Board placed more restrictive conditions on Mellon in the context of its acquisition of TBC.

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight and Investigations

cc: The Honorable Dan Schaefer

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

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ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

ALAN GREENSPAN
CHAIRMAN

February 28, 1994

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives
Washington, D.C. 20515-6116

Dear Mr. Chairman:

Thank you for your letter of February 14, 1994, requesting information regarding the proposal by Mellon Bank Corporation to acquire The Dreyfus Corporation.

Mellon has filed a draft application with the Federal Reserve Bank of Cleveland under the Bank Holding Company Act to acquire a trust company, a savings association, and several other nonbanking companies, including a real estate advisory company and several community development companies, that are currently owned by Dreyfus. Once the application is filed in final form, the Board will, in accordance with its regulations, invite public comment on this application and make it available to the public.

We understand that Mellon proposes to acquire and hold Dreyfus and its major affiliates as subsidiaries of Mellon Bank, N.A. Consequently, the main part of the proposal is subject to review by the Comptroller of the Currency under the National Bank Act. We understand that, in view of the complexity and precedential nature of the proposal, the Comptroller has invited public comment on this aspect of the proposal.

Enclosed is a more detailed staff response to the questions posed in your letter. I hope this information is useful.

Sincerely,

Enclosure

<u>Federal Reserve Board Staff Responses to Questions Posed by Letter of February 14, 1994</u>

1. The Subcommittee understands that part of the Mellon-Dreyfus proposed merger is subject to approval by the Federal Reserve Board (Board).

   a. Please explain in detail any applications that the Board is considering as part of the proposed transaction. Does the Board plan to obtain public comment prior to making its decision?

Mellon has determined to acquire and hold The Dreyfus Corporation and the major subsidiaries of Dreyfus as operating subsidiaries of Mellon Bank, N.A. No application for Board approval under the Bank Holding Company Act is required for this part of the acquisition. Instead, Mellon must file a notice with the Comptroller of the Currency pursuant to the Comptroller's rules. The Comptroller has recently invited public comment on this acquisition.

Another part of the proposal does require Board review under the Bank Holding Company Act. Dreyfus currently owns a small savings association, a small trust company and several other nonbanking companies, including a real estate advisory company and several community development companies. Mellon has begun the process of filing applications for the Board's approval under section 4(c)(8) of the Bank Holding Company Act to acquire and hold these companies as subsidiaries of the bank holding company.

As of this date, these applications have been submitted in draft, and substantial additional information must be submitted before these applications can be accepted for processing. Once these applications are submitted in final by

Mellon and accepted for processing by the Federal Reserve Bank of Cleveland, the Board will invite public comment on these applications in accordance with the Board's rules, and will make the applications available to the public.

> b. Please discuss the Board's views on the advisability of banks engaging directly in the mutual fund business. Are there adequate bank controls and compliance systems? What types of firewalls or other protections are needed? Please advise the Subcommittee whether there are alternative approaches to structuring the Mellon-Dreyfus merger that would better address the (1) safety and soundness and (2) investor protection concerns raised by the proposed merger.

The Board believes that there are a number of aspects of the mutual fund business in which banks and bank holding companies may be involved. Banks and bank holding companies have for many years served as the investment advisor to mutual funds, and the courts have determined that these activities are consistent with the Glass-Steagall Act. The agencies and the courts have also permitted banks and bank holding companies to serve as agent in the purchase and sale of mutual fund shares on behalf of customers, and to provide investment advice to customers regarding the purchase and sale of mutual fund shares. In addition, banks and bank holding companies are permitted to provide administrative and custodial services to mutual funds, and to serve as the transfer agent and registrar for mutual funds. The Board has determined, however, that a bank holding company may not sponsor, organize or control a mutual fund or

engage in underwriting or the distribution of shares of a mutual fund. 12 CFR 225.125.

In order to address potential customer confusion and conflicts of interest, the Board has imposed several conditions on bank holding companies that advise mutual funds. In particular, a bank holding company that advises a mutual fund may not lend to the mutual fund, acquire shares of the mutual fund for its own account, acquire shares of the mutual fund through any fiduciary account for which the bank holding company has sole discretion, or accept shares of the mutual fund as collateral for a loan that is for the purpose of purchasing shares of the fund. In addition, a bank holding company may not act as the investment advisor to a mutual fund that has a name that is identical or similar to the name of the bank holding company. 12 CFR 225.125(f) and (g).

In cases in which the bank holding company provides investment advisory or brokerage services to customers regarding shares of any mutual fund that is advised by the bank holding company, the Board requires that the bank holding company provide a number of disclosures in writing to the customer. In particular, the bank holding company must inform the customer that shares of the mutual fund are not deposits, are not insured by the FDIC, and are not guaranteed by the bank or bank holding company. 12 CFR 225.125(h). The bank holding company must also disclose any relationship that it (or any of its affiliates) has with the fund. A bank holding company must provide similar

written disclosures in connection with any activities as a so-called full service broker. 12 CFR 225.25(b)(15).

The Board, in conjunction with the OCC, FDIC and OTS, recently issued a joint policy statement that provides additional guidance regarding the manner and location of mutual fund sales in bank offices. This guidance is designed to assure that the sale of mutual funds is done by individuals who are in a clearly marked location that is separate from the deposit-taking area of the bank, and that the sale of mutual funds is conducted only by qualified and trained individuals. The policy statement also reinforces the disclosure requirements discussed above.

Banking organizations are permitted to own broker/dealers either as a holding company subsidiary or as a subsidiary of the bank. The question of the appropriate structure is left largely to the discretion of management of the banking organization.

Regardless of the structure, however, the broker/dealer is subject to all of the requirements of the Federal securities laws applicable to brokers and dealers, including registration requirements, the jurisdiction of the Securities Exchange Commission, and the SEC's rules governing mutual fund activities. In addition, the Board, in the case of an acquisition through the holding company under the Bank Holding Company Act, and the Comptroller, in the case of an acquisition through a national bank under the National Bank Act, have full authority to impose conditions and limitations on the ownership of the broker/dealer

and on its activities that are needed to address safety and soundness and consumer protection concerns.

2. The OCC letter of January 12, 1994 states (p. 2, fn. 2) that "[t]he OCC will carefully consider the consequences of the structure of the proposed transaction for the capital position of both Mellon and Dreyfus." As you know, MBC has stated that "a principal reason" for structuring the transaction along the lines proposed is so that Mellon Bank can consolidate Dreyfus' capital with its own capital base.

   Dreyfus Service Corporation (DSC) is registered with the SEC, the NASD and all fifty states as a broker-dealer, and as such, is subject to necessary and appropriate financial responsibility standards including the applicable net capital requirements under section 15(c)(3) of the Exchange Act. We are concerned that the capital of the Dreyfus broker-dealer subsidiary will be consolidated with that of Mellon Bank, potentially harming the subsidiary's compliance with its financial responsibility requirements under the federal securities laws.

   Both the Board (in your Section 20 orders) and the Federal Deposit Insurance Corporation (FDIC) (in 12 C.F.R. section 337.4(b)(3)) have adopted measures to ensure the adequate capitalization of securities subsidiaries and prevent the double leveraging of securities subsidiaries' capital. Both provide that the parent entity's investment in a securities subsidiary will not be counted toward satisfaction of the parent entity's capital requirement. Please explain the rationale for your position. What would be the consequences of the failure of the OCC to make similar provision for ensuring the separate capitalization of national bank subsidiaries? What capital conditions should the OCC require in connection with the proposed transaction?

Generally accepted accounting principles as well as the reporting requirements of the Securities Exchange Commission require that, as a general rule, the assets, liabilities and capital accounts of a subsidiary be reported on a consolidated basis with the assets, liabilities and capital accounts of the

parent company. The banking agencies generally adopt this same requirement, because, for most purposes, it provides a useful overall picture of the financial condition of a banking organization.

As you note in your letter, the Board has required that--solely for purposes of the Board's capital adequacy rules--bank holding companies that operate so-called section 20 securities underwriting affiliates not consolidate the balance sheets of these affiliates with the rest of the organization. Instead, the amount of the organization's investment in the section 20 affiliate and other elements of the capital accounts of these affiliates are deducted from the accounts of the consolidated holding company. This capital treatment was adopted as a conservative response to concern regarding the potential financial risk of securities underwriting activities. In effect, under this treatment, the section 20 affiliate could fail, with the organization losing all of its investment, without affecting the organization's financial strength as presented on its financial statement. The Board has not, as a general matter, required bank holding companies to deduct from their capital investments in broker/dealer subsidiaries that engage only in securities brokerage activities on behalf of customers.

It is important to note that the consolidated capital ratios reported by a banking organization are not intended to indicate the amount of capital funds that are available to be placed in a single subsidiary bank in the event that the bank

experiences financial stress. For example, while a multi-bank holding company reports the capital accounts of all of its subsidiary banks on a consolidated basis, that consolidated capital includes capital in individual banks that must support the assets in each of those banks. Capital that is needed to support one of the banks in that multi-bank holding company is not likely to be available to another bank in that same organization, even though the capital is reported on a consolidated basis at the parent holding company level.

The Board has not had occasion to consider whether it is appropriate to apply the section 20 capital treatment to an investment by a bank holding company in a broker/dealer such as Dreyfus. The Board would carefully consider the risk of such an investment to the holding company organization and to its bank affiliates. However, a proper resolution of these matters depends on the specific facts of the proposal.

3. Please comment on the OCC's statement (p. 6) that "[b]ecause establishment of operating subsidiaries is part of the business of banking, it is not proscribed by 12 U.S.C. section 24(7) provisions on purchasing corporate stock." Please explain how you distinguish between "incidental" activities and those "closely related to banking," which are subject to the requirements of the Bank Holding Company Act.

   a. Please provide the Subcommittee with a list or chart comparing those activities that the OCC has deemed "incidental to banking" to those activities that the Fed has deemed "closely related to banking" for the purpose of the Bank Holding Company Act. If many activities overlap (as the Subcommittee believes to be the case), what is the purpose for two different regulatory schemes?

The National Bank Act permits national banks to conduct "all such incidental powers as shall be necessary to carry on the business of banking". 12 U.S.C. 24(Seventh). This provision has been interpreted by the courts to permit national banks to conduct activities that are "convenient or useful in connection with the performance of one of the bank's established activities pursuant to its express powers under the National Bank Act." M&M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377 (9th Cir. 1977). The OCC's rules regarding the establishment of an operating subsidiary limit the operating subsidiary to activities that a national bank is permitted to conduct directly.
12 CFR 5.34.

The Bank Holding Company Act provides that the Board may authorize bank holding companies to invest in companies that engage in activities that are "so closely related to banking as to be a proper incident thereto." 12 U.S.C. 1843(c)(8). In considering whether an activity is "closely related to banking," the Board and the courts have considered whether:

1) banks generally have, in fact, provided the service;

2) banks generally provide services that are operationally or functionally so similar to the proposed service as to equip them particularly well to provide the proposed service; or

3) banks generally provide services that are so integrally related to the proposed service as to require their provision in a specialized form. See National Courier Ass'n v. Board, 516 F.2d 1229 (D.C.Cir. 1975).

The Board may also consider any other factor indicating that the activity has a reasonable connection to banking. See

Alabama Ass'n of Insurance Agents v. Board of Governors, 533 F.2d 224 (5th Cir. 1976). Thus, while it may be sufficient for purposes of the closely related test that national banks are permitted to conduct an activity, it is not a prerequisite. The greater breadth of the closely related test explains a number of the activities--such as limited securities underwriting activities--that bank holding companies may perform that are not permissible for national banks to conduct directly.

Attached is a list of all of the activities that the Board has to date determined to be "closely related to banking" for purposes of section 4(c)(8) of the BHC Act. The Board is not aware that the OCC publishes a list of the activities that are deemed to be incidental to banking under the National Bank Act.

b. Please explain the nature and extent of the Board's authority under Section 4 of the Bank Holding Company Act, and whether this provision provides the Board with the authority to regulate national and state-chartered bank subsidiaries in addition to bank holding companies. Does the existing bifurcated regulatory scheme (with the OCC as primary regulator of bank subsidiaries) undermine consolidated bank holding company regulation?

The Board's Regulation Y permits national banks that are controlled by a bank holding company to own shares of an operating subsidiary provided the investment is in compliance with the regulations of the Comptroller. 12 CFR 225.22(d)(1). Similarly, the Board's Regulation Y permits state banks owned by a bank holding company to own all (but, except for directors' qualifying shares, not less than all) of the shares of a company

that engages solely in activities in which the parent bank may engage, subject to the same limitations as if the bank were engaging in the activity directly. 12 CFR 225.22(d)(2)(ii).

The Board has determined that the provisions of section 4 of the Bank Holding Company Act do not apply to the direct activities of state and national banks that are subsidiaries of bank holding companies. The courts have confirmed this reading of the Bank Holding Company Act. See Independent Insurance Agents of America v. Board of Governors, 838 F.2d 627 (2d Cir. 1988).

4. Mellon's Legal Memorandum notes at page 36 that "[b]anks have increasingly sought to decrease the roles of third party distributors in the marketing of their proprietary mutual funds and commensurately to increase their own role and that of their broker-dealer affiliates." Concerns have been raised that third party distributors in general are often mere shell companies that do very little and that usually subcontract out all activities, including advertising and marketing, to the bank. The small fees typically paid to such distributors bear out the lack of functions.

   a. Please explain why an entity that does not perform the functions of marketing, selling, or advertising a mutual fund, as would seem to be the case in the Mellon/Dreyfus situation, should nonetheless be considered to be the "distributor" of such fund for Glass-Steagall purposes. What is your understanding of the role contemplated for Dreyfus Service Corporation or any other affiliate of Mellon in the process of marketing shares of the Dreyfus funds? How does that role satisfy the applicable statutory language and its intent? What is the appropriate role of a distributor for Glass-Steagall purposes?

The term "distributor" is often applied to one of the companies that is involved in sponsoring, managing and/or selling

shares of mutual funds. However, the Glass-Steagall Act does not define the term "distributor", and a review of prospectuses for mutual funds indicates that the duties of the company denominated as the distributor varies widely across funds.

The designation of an entity as "a distributor" of mutual funds, therefore, is not itself a relevant inquiry under the Glass-Steagall Act. The Glass-Steagall Act prohibits a bank from engaging in "the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks...or other securities." (Sections 16 and 21 of the Glass-Steagall Act, 12 U.S.C. 24(Seventh) & 378). The Supreme Court has indicated that this also includes a prohibition on engaging in the "public sale" of securities. Thus, the relevant inquiry under the Glass-Steagall Act is whether, under the proposal, Mellon Bank would, through its proposed Dreyfus operating subsidiaries, be engaged in any of these prohibited activities.

Our understanding of the activities of Dreyfus Service Corporation are limited to the description in the notice provided to the OCC, and the Board has no additional information on this matter. As described below, the Board has not had occasion to consider whether a company that engages in the same activities conducted by Dreyfus Service Corporation would be engaged in "issuing, underwriting, selling, [the public sale], or distributing, at wholesale or retail, or through syndicate participation, stocks...or other securities."

b. In April 1993, the Board-approved Mellon's purchase of The Boston Company (TBC), a firm that, among other things, provides investment advice and administrative services to mutual funds, and authorized Mellon to continue providing such services through TBC. However, as part of the approval, Mellon pledged to terminate TBC's role as a sponsor of mutual funds, and represented that no Mellon entity would be involved in the distribution of shares of any mutual fund.

Nonetheless, the Mellon-Dreyfus application to the OCC would appear to permit Dreyfus entities (to be acquired by Mellon) to continue to be involved in wide-scale distribution of mutual funds. Is the Mellon-Dreyfus application consistent with the TBC approval? Please comment on the different regulatory approaches taken by the Board and the OCC in these similar circumstances, and explain why the Board placed more restrictive conditions on Mellon in the context of its acquisition of TBC.

The Mellon proposal to acquire The Boston Company ("TBC") did not raise the issue of whether the acquisition would cause Mellon to be engaged in the distribution of shares of a mutual fund. In that case, TBC had originally sponsored and distributed shares for several of the mutual funds advised by TBC, and was responsible for advertising and marketing the shares of the mutual funds advised by TBC. However, as noted in the Board's order in that case, Mellon did not propose to continue these activities after the acquisition of TBC. Rather, Mellon indicated that, following the acquisition, TBC did not propose to engage in any sales activities with regard to mutual fund shares, enter into any distribution agreement, develop any marketing plans for mutual funds, or engage in advertising activities with respect to mutual funds. Mellon Bank Corporation, 79 Federal

Reserve Bulletin 626, n. 15 (1993). Thus, the Board's order in that case is limited to a general determination that administrative services (when conducted within the limits described in the Board's order) are closely related to banking for purposes of the Bank Holding Company Act.

The Board was not called on in the Mellon case, and did not reverse or change the restriction in its interpretive rule that bank holding companies may not engage in underwriting or the distribution of shares of a mutual fund advised by the holding company. 12 CFR 225.125. Thus, because of the more limited scope of the Mellon/TBC proposal, the Board did not consider the permissibility of some of the activities conducted by Dreyfus, or whether conditions or limitations are appropriate for the conduct of these activities by a banking organization.

The OCC continues to have the Mellon proposal under review, and has full authority to impose conditions on the ownership of Dreyfus by Mellon Bank, as well as on the activities of Dreyfus. It is not possible at this time to determine whether there is any inconsistency between the action of the Comptroller and the Board's decision in Mellon/TBC.

Attachment

3000.0.2 APPENDIX 1—ACTIVITIES APPROVED BY THE BOARD AS BEING CONSIDERED "CLOSELY RELATED TO BANKING" UNDER SECTION 4(C)(8) OF THE BANK HOLDING COMPANY ACT (SECTION 225.25(B) OF REGULATION Y)

Permitted by Regulation	*Year Added*
1. Making, acquiring, or servicing loans or other extensions of credit for: Mortgage banking[1] Finance companies: consumer, sales, and commercial[1] Credit cards[1] Factoring	1971
2. Industrial bank, Morris Plan bank, industrial loan company	1971
3. Trust company[1]	1971
4. Investment or financial advising	1971
a. Providing advisory services to open-end investment companies	1972
b. Providing financial advice, including rendering fairness opinions and valuation services, in connection with institutional customers with respect to mergers, acquisitions, divestitures, joint ventures, leveraged buyouts, reorganizations, recapitalizations, capital structurings, and financing transactions (including private and public financings and loan syndications); and conducting feasibility studies	1992
c. Providing financial and transaction advice to institutional customers regarding the structuring and arranging of swaps, caps, and similar transactions relating to interest rates, currency exchange rates or prices, and economic and financial indices and similar transactions	1992
d. Providing financial advice to:	
(1) State and local governments; and	1973
(2) Foreign governments including foreign municipalities and agencies of foreign governments, such as with respect to issuance of their securities	1992
5. a. Full-payout leasing of personal and real property[2]	1971
b. Providing certain higher residual value leasing for tangible personal property, including acting as agent, broker, or advisor in leasing such property	1992
6. Investments in community welfare projects	1971
7. Data processing[3]	1971
8. a. Acting as insurance agent or broker primarily in connection with credit extensions[4]	1971
b. Underwriting credit life and credit accident and health insurance related to an extension of credit	1972

	Permitted by Regulation	*Year Added*
9.	Operating a savings association	1989
10.	Providing courier services	1973
11.	Management consulting to unaffiliated bank and nonbank depository institutions[5]	1974
12.	Issuance and sale at retail of money orders with a face value of not more than $1,000, savings bonds, and the issuance and sale of travelers checks[6]	1979
13.	a. Performing appraisals of real estate	1980
	b. Performing appraisals of personal property[7]	1986
14.	Arranging commercial real estate equity financing[7]	1983
15.	a. Securities brokerage[8]	1982
	b. Securities brokerage and related securities credit activities (pursuant to Regulation T)	1992
	c. Securities brokerage in combination with advisory services	1992
16.	Underwriting and dealing in government obligations and money market instruments[9]	1984
17.	Foreign exchange advisory and transmittal services[9]	1984
18.	Futures commission merchant activities[9]	1984
19.	Investment advice on financial futures and options on futures	1986
20.	Consumer financial counseling	1986
21.	Tax planning and preparation	1986
22.	Check-guaranty services	1986
23.	Operating a collection agency	1986
24.	Operating a credit bureau	1986

1. Amended in 1974 to narrow in some respects and expand in others.
2. Expanded in 1974 to include real property leases.
3. Expanded in 1982 to permit bank holding companies to engage in data processing and transmission services as specified by the Board.
4. Scope narrowed to conform to court decisions in 1979 and 1981 and in 1982 it was further narrowed by Title VI of the Garn–St Germain Depository Institutions Act.
5. Expanded in 1982 to include nonbank depository institutions.
6. This activity was initially approved by order on individual application (1973), and did not include the issuance of travelers checks. In 1981, the activity was expanded to include issuance of such instruments. In 1984 the activity was expanded to provide for the issuance of money orders as part of the regulatory review and overhaul of Regulation Y, effective February 6, 1984.
7. Activity was initially approved by order on an individual application in July 1982. The amendment to Regulation Y that added this nonbank activity became effective on September 25, 1982.
8. Modifies a previous position taken by the Board in acting on an individual application to acquire a retail discount securities broker.
9. This nonbank activity was approved as the result of a complete regulatory review and overhaul of Regulation Y, revised effective February 6, 1984.

3000.0.3 APPENDIX 2—ACTIVITIES CONSIDERED "CLOSELY RELATED TO BANKING" UNDER SECTION 4(C)(8) OF THE BANK HOLDING COMPANY ACT

Permitted by Order on an Individual Basis[1]	*Year Approved*	*Manual Section 3600.*
1. Operating a "pool-reserve plan" for the pooling of loss reserves of banks with respect to loans to small businesses	1971	1
2. Operating a thrift institution in Rhode Island	1972	2
3. Buying and selling gold and silver bullion and silver coin	1973	3
4. Operating a guaranty savings bank in New Hampshire	1975	4
5. Operating an Article XII New York Investment Company	1977	5.1
6. Retail check authorization and check guarantee[2]	1979	
7. Providing consumer-oriented financial management courses[3]	1979	
8. Engaging in commercial banking activities through foreign branches of a Nonbank Delaware company	1982	5.2
9. Acquisition and operation of a distressed savings and loan association[4]	1982	
10. Operating a limited-purpose National bank for purposes of avoiding usury ceilings	1983	10
11. Brokering options on securities issued or guaranteed by the U.S. Government and options on U.S. and foreign money market instruments	1983	6.1
12. Operating a "nonbank bank" through a limited purpose commercial bank charter	1984	
13. Brokering options in foreign currency on exchanges regulated by the SEC	1984	6.2
14. Providing financial feasibility studies for private corporations;[8] performing valuations of companies and of large blocks of stock for a variety of purposes and providing expert witness testimony on behalf of utility firms in rate cases	1984	11
15. Executing and clearing CFTC-regulated options on bullion and foreign exchange on authorized commodity exchanges and providing investment advice	1984	6.3
16. Issuing consumer-type payment instruments having a face value of not more than $10,000	1984	12.1

Permitted by Order on an Individual Basis[1]	Year Approved	Manual Section 3600.
17. Tax preparation services performed in a nonfiduciary capacity[5]	1984	
18. FCM brokerage of futures contracts on a municipal bond index, and related futures advisory services	1985	13.1
19. FCM brokerage of futures contracts on stock indexes, and options on such contracts	1985	13.2
20. Credit card authorization services and lost/stolen credit card reporting services	1985	14
21. Employee benefits consulting activities	1985	15.1
22. Issuance of sale of official checks with no limitation on the maximum face value, but subject to certain limitations	1985	12.2
23. Acting as a municipal securities brokers' broker	1985	7.1
24. Expanded student loan servicing activities	1985	16
25. Underwriting and reinsuring home mortgage redemption insurance[6]	1986	17.1
26. Providing portfolio investment advice in connection with securities brokerage services subject to certain conditions[8]	1986	
27. Printing and selling checks and related documents that require MICR-encoded information for depository institutions	1986	12.3
28. Engaging in commercial paper placement activities to a limited extent	1986	19.1
29. Providing advice regarding the structuring of and arranging for loan syndications, interest rate "swap", interest rate "cap" and similar transactions[8]	1986	
30. Providing limited advisory services with respect to futures contracts on stock indexes and options on such futures contracts in connection with FCM brokerage activities	1987	18.1
31. Providing cash management services on a stand-alone basis	1987	20
32. Underwriting and dealing in commercial paper to a limited extent	1987	21.1
33. Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage related securities, and commercial paper	1987	21.2
34. Underwriting and dealing in, to a limited extent, municipal revenue bonds, mortgage related securities, consumer-receivable-related securities and commercial paper	1987	21.3

Permitted by Order on an Individual Basis[1]	Year Approved	Manual Section 3600.
35. Engaging in securities brokerage, clearing, and other services in connection with a system for the trading of options on U.S. Government securities[7]	1987	
36. Providing discretionary investment management services for "institutional customers" and a BHC's affiliates in connection with Board-approved brokerage services[8]	1987	
37. Providing community-development advisory and related services	1987	22
38. Issuing and selling drafts and wire transfers that are payable in foreign currencies without limitation as to their face amount, but subject to certain limitations	1988	12.4
39. Providing financing advice to the Canadian federal and provincial governments, such as with respect to the issuance of their securities in the U.S.[8]	1988	
40. Issuing and selling mortgage-related securities backed by the guarantees of the Government National Mortgage Association	1988	23
41. Providing management services to failed savings and loan associations under the FHLBB's Management Consignment Program	1988	15.2
42. Providing investment advice concerning futures and options on futures contracts, such as advice to be given to a limited number of institutional investors and without registration as a CTA or an FCM	1988	18.2
43. Engaging in permissible title insurance agency activities pursuant to grandfather provisions in section 225.25(b)(8)(vii) of Regulation Y	1988	17.2
44. Underwriting and dealing in, to a limited extent, corporate debt and equity securities	1989	21.4
45. Providing advice relating to the structuring of and arranging for currency swaps[8]	1989	
46. Offering full brokerage services to institutional and retail customers for ineligible securities[8]	1989	
47. Acting as a specialist in options on foreign exchange	1989	6.5
48. Acting as a dealer and broker with respect to interest rate and currency swaps and related transactions	1989	7.2
49. Acting as agent in the private placement of all types of securities	1989	19.2

Permitted by Order on an Individual Basis[1]	Year Approved	Manual Section 3600.
50. Engaging in personal property leasing transactions that allow a bank holding company to rely for its compensation on an estimated residual value of leased personal property to up to 100 percent of the acquisition cost of the leased property[8]	1990	
51. Providing financial advice to the Japanese national and municipal governments and their agencies such as with respect to the issuance of their securities in the United States[8]	1990	
52. Engaging in the purchase and sale of platinum coins issued by the Canadian and Australian governments as legal tender	1990	3
53. Acting as a registered options trader on foreign exchange options	1990	6.6
54. Entering into currency swap transactions for a bank holding company's hedging its own position in foreign currency	1990	25
55. Acting as a sales tax refund agent	1990	24.1
56. Cashing U.S. dollar payroll checks drawn on unaffiliated banks	1990	24.2
57. Acting as agent in the sale of annuities (exemption G companies only)	1990	
58. Providing real estate settlement activities through a permissible title insurance agency (exemption G companies only)	1990	26
59. Providing non-financial futures advice	1990	18.3
60. Providing combined foreign exchange and government securities advisory and execution services	1990	18.3
61. Providing management consulting services to failed savings and loan associations	1990	15.2
62. Providing asset management services to certain governmental agencies and to unaffiliated financial institutions with troubled assets	1990	15.3
63. Trading for a company's own account in futures, options, and options on futures based on U.S. government securities and certain money market instruments	1991	6.4
64. Acting as a conduit in securities borrowing and lending	1992	

1. In approving these activities, the Board did so without expanding the list of permissible activities under section 225.25(b) of Regulation Y.

2. This nonbanking activity was included by the Board within the list of permissible nonbanking activities in section 225.25(b)(22) of Regulation Y, effective December 15, 1986.

3. This nonbanking activity was included by the Board within the list of permissible nonbanking activities in section 225.25(b)(20) of Regulation Y, effective December 15, 1986.

4. This activity was included on the list of permissible nonbanking activities of Regulation Y, section 225.25(b)(9), effective October 10, 1989.

5. This nonbanking activity was included by the Board within the list of permissible nonbanking activities in section 225.25(b)(21) of Regulation Y, effective December 15, 1986.

6. Added to Regulation Y, effective October 3, 1986.

7. On February 4, 1988, the Board's order was vacated (refer to 1988 FRB 256, 1987 FRB 815).

8. Incorporated into section 225.25(b) of Regulation Y by the Board on April 22, 1992.

Activities permitted by order

65. Acting as administrator to mutual funds. (1993)

66. "Clearing only" activities as a futures commission merchant. (1993)

67. Acting as a futures commission merchant in executing and clearing, and clearing without executing, futures and options on futures on non-financial commodities. (1993)

68. Acting as a dealer-manager in soliciting tender offers. (1993)

69. Providing electronic benefit transfer services, stored value card services, and electronic data interchange services. (1993)

70. Providing career counseling services for financial organizations or individuals seeking financially-related positions. (1993)

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 2, 1994

The Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Greenspan:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

In connection with the Subcommittee hearings today and tomorrow on this matter, serious concerns have been raised regarding the adequacy of the protections that the banking laws afford customers who purchase securities or investment advice in banks. Accordingly, I am transmitting the enclosed 55-page draft table comparison of the regulation of broker-dealers and investment advisers under the federal securities laws versus under the federal banking laws. The table summarizes the principal relevant statutes, regulations, and guidelines administered by the Securities and Exchange Commission and by the federal banking agencies. The Subcommittee will be keeping the hearing record open for 30 days to accommodate our request that you carefully review this document and submit any corrections you deem necessary to make this table accurate and complete.

If you have any questions about this request, please contact Consuela M. Washington of the staff at (202) 225-3147. Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

Enclosure

cc: The Honorable Dan Schaefer

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 31, 1994

The Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Chairman Greenspan:

This is with reference to the Subcommittee's letter of March 2, 1994 asking you to review our draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and under the federal banking laws. The table does not include all the federal securities laws and rules, nor does it address the regulation of banks as transfer agents, municipal, or government securities dealers. This is consistent with the scope of the Subcommittee's inquiry as well as the table's stated scope.

At the request of the Office of the Comptroller of the Currency, we are extending the deadline for your responses to the close of business on Friday, April 8, 1994, at which time we will be closing the hearing record and taking the steps to go to prompt printing. It would be helpful if the recipients of the March 2 letter would meet and discuss (and where possible coordinate) your responses. In any event, your transmittal letters for your corrections should indicate the name and phone number of a contact person on your staff, in the event that we have questions about your submission.

The Subcommittee greatly appreciates your cooperation and assistance with our work. We firmly believe that these issues are of vital importance to the protection of the public.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer
The Honorable Andrew C. Hove
The Honorable Arthur Levitt
The Honorable Eugene A. Ludwig

ONE HUNDRED THIRD CONGRESS

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REID P.F. STUNTZ, STAFF DIRECTOR/CHIEF COUNSEL

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

February 14, 1994

The Honorable Andrew C. Hove
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Chairman Hove:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

As a starting point, we have reviewed the copy of the Notice of the transaction and supporting documentation that was delivered by MBC to the Committee on Energy and Commerce on January 3, 1994, as well as the responses of MBC and Dreyfus, the Securities and Exchange Commission (SEC), and the Comptroller of the Currency (OCC), responding to the December 20, 1993 Gonzalez-Dingell letter. In order to assist the Subcommittee in its investigation and in preparation for upcoming hearings, your cooperation is requested in providing the following responses, information, and documents by the close of business on Friday, February 25, 1994.

1. Mellon's Legal Memorandum argues that approval of its Notice "would be fully consistent with existing regulatory precedent" and that failure to approve the Notice, even if the activities are deemed to be illegal, would place national banks "at a serious competitive disadvantage." The Memorandum states at page 44 that "the Federal Deposit Insurance Corporation has issued a ruling [to the Wilmington Trust Co.] on mutual funds that goes well beyond what is proposed here. The FDIC ruling permits a subsidiary of a non-member bank to advise, administer, sponsor and even distribute mutual funds." Please provide the Subcommittee with a copy of that opinion letter. How

many similar applications has the FDIC approved? Please provide a list thereof. Would the FDIC's opinion be different if the Wilmington application involved a bank, or bank operating subsidiary, rather than a subsidiary of a bank holding company? If so, please explain why.

a. Has the FDIC permitted bank mutual fund sales and advisory services to be performed directly by state banks? Please explain what conditions and limitations have been imposed by FDIC on bank advisory services and sales and marketing of mutual funds and other noninsured investment products in order to eliminate consumer confusion, protect the safety and soundness of the bank and the Federal deposit insurance funds, and for the protection of investors, and how compliance with those conditions and limitations is implemented, examined for and enforced.

b. With specific reference to these examinations, do you examine merely for the existence of systems and records or do you utilize testers to ascertain actual compliance? Please provide copies of examination manuals pertaining to bank securities activities.

2. Please inform the Subcommittee of the current number and asset share of banks insured by the FDIC by type (e.g., national banks, state member banks, and state non-member banks) and total. Please identify the federal regulator for each category of institution. Please provide the Subcommittee with the number of FDIC-insured banks that are engaged directly in securities sales or advisory activities. Also, please provide the number of such banks engaged in such activities through bank operating subsidiaries, and through affiliates.

3. Both for (1) the insured depository institutions for whom FDIC is the federal regulator and (2) the insured depository institutions for whom FDIC is not the federal regulator, please advise the Subcommittee of the extent to which and the manner by which FDIC is informed and aware of the nature and extent of securities activities being conducted in such institutions and their affiliates, the existence of appropriate systems and controls, and actual compliance with relevant polices, procedures and laws and regulations. Please be specific. Do you examine for, and are you aware of, any customer complaints resulting from bank securities activities? Please provide

The Honorable Andrew C. Hove
Page 3

details of any enforcement actions that the FDIC has brought relating to bank securities activities.

4. Have any of the monies paid by FDIC to resolve failed institutions been paid to satisfy the claims of purchasers of investment products sold by such institutions? If so, please identify those matters.

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

RECEIVED
94 FEB 28 PM 2:38
ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES

February 25, 1994

Honorable John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter regarding the securities activities of financial institutions.

You may be assured that the Federal Deposit Insurance Corporation takes seriously its responsibility to supervise retail sales of nondeposit investment products. Because the types of activities engaged in by banks are changing rapidly, our supervisory role continues to evolve. We are studying the issues relating to these activities and are prepared to adjust our guidance to the industry and our examination procedures as warranted.

We are pleased to enclose answers to your enumerated questions which set forth our current policies and procedures.

If you or your staff have further questions, our Office of Legislative Affairs can be reached at 898-8730.

Sincerely,

Andrew C. Hove

Andrew C. Hove, Jr.
Acting Chairman

Enclosures

Responses to Questions by Chairman Dingell

Q.1. **Mellon's Legal Memorandum argues that approval of its Notice "would be fully consistent with existing regulatory precedent" and that failure to approve the Notice, even if the activities are deemed to be illegal, would place national banks "at a serious competitive disadvantage." The Memorandum states at page 44 that "the Federal Deposit Insurance Corporation has issued a ruling [to the Wilmington Trust Co.] on mutual funds that goes well beyond what is proposed here. The FDIC ruling permits a subsidiary of a non-member bank to advise, administer, sponsor and even distribute mutual funds." Please provide the Subcommittee with a copy of that opinion letter. How many similar applications has the FDIC approved? Please provide a list thereof. Would the FDIC's opinion be different if the Wilmington application involved a bank, or bank operating subsidiary, rather than a subsidiary of a bank holding company? If so, please explain why.**

A.1. Securities subsidiaries of Wilmington Trust Company are subject to the provisions of 12 C.F.R. § 337.4. Based on the provisions of this regulation and the representations made by Wilmington Trust Company, the FDIC issued a "no objection" letter to the bank on September 2, 1992 which is attached. We have had no other notices similar to the Wilmington Trust Company notice. The Wilmington Trust Company application involved a bank and its subsidiary, not a bank holding company.

On December 28, 1984, the FDIC implemented its regulation on securities activities of subsidiaries of insured nonmember banks and bank transactions with affiliated securities companies. The regulation is codified at 12 C.F.R. § 337.4. At that time, the FDIC determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company affiliated with a company engaged in securities activities if authorized under state law. At the same time, the FDIC found that some risk may be associated with those activities. In order to address that risk, the FDIC regulation (1) defines bona fide subsidiary, (2) requires notice of intent to acquire or establish a securities subsidiary, (3) limits the permissible securities activities of insured nonmember bank subsidiaries, and (4) places certain other restrictions on loans, extensions of credit and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities. Each of these issues, which directly relate to the decision to send a no action letter to Wilmington Trust Company, is discussed below.

The term "bona fide" subsidiary means a subsidiary of an insured nonmember bank that at a minimum: (1) is adequately capitalized, (2) is physically separate and distinct in its operations from

the operations of the bank, (3) maintains separate accounting and other corporate records, (4) observes separate corporate formalities such as separate board of directors meetings, (5) maintains separate employees who are compensated by the subsidiary, (6) shares no common officers with the bank, (7) a majority of the board of directors is composed of persons who are neither directors nor officers of the bank, and (8) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

This definition is imposed to ensure the separateness of the subsidiary and the bank. This separation is necessary as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake. Also, the separation safeguards the soundness of the parent bank.

The regulation provides that the insured non-member bank must give the FDIC written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummating the acquisition or commencement of the operation of the subsidiary. These notices serve as a supervisory mechanism to apprise the FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries that pose potential risks to which the bank otherwise would not be exposed.

Activities of the subsidiary are limited in that it may not engage in the underwriting of securities that would otherwise be prohibited to the bank itself under the Glass Steagall Act unless the subsidiary meets the bona fide definition and the activities are limited to (1) underwriting of investment quality debt securities, (2) underwriting of investment quality equity securities, (3) underwriting of investment companies not more than 25 percent of whose investments consist of investments other than investment quality debt securities and/or investment quality equity securities, or (4) underwriting of investment companies not more than 25 percent of whose investments consist of investments other than obligations of the United States or United States Government agencies, repurchase agreements involving such obligations, bank certificates of deposit, banker's acceptances and other bank money instruments, short-term corporate debt instruments, and other similar investments normally associated with a money market fund.

A subsidiary may engage in underwriting other than that listed above if it meets the bona fide definition and the following conditions are met:

(a) The subsidiary is a member in good standing of the National Association of Securities Dealers;

(b) The subsidiary has been in continuous operation for the five-year period preceding the notice to the FDIC;

(c) No director, officer, general partner, employee or 10 percent shareholder has been convicted within five years of any felony or misdemeanor in connection with the purchase or sale of any security;

(d) Neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders is subject to any state or federal administrative order or court order, judgment or decree arising out of the conduct of the securities business;

(e) None of the subsidiary's directors, officers, general partners, employees or 10 percent shareholders are subject to an order entered within five years issued by the Securities and Exchange Commission pursuant to certain provisions of the Securities and Exchange Act of 1934 or the Investment Advisors Act of 1940; and

(f) All officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

A bank's investment in a subsidiary engaged in securities activities that would be prohibited to the bank under the Glass-Steagall Act is not counted toward the bank's capital, i.e., the investment in the subsidiary is deducted before compliance with capital requirements is measured.

An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures or notes, or other securities, or acts as an investment advisor to any investment company may not engage in any of the following transactions:

(1) Purchase in its discretion as fiduciary any security currently distributed, underwritten or issued by the subsidiary unless the purchase is authorized by a trust instrument or is permissible under applicable law.

(2) Transact business through the trust department with the securities firm unless the transactions are at least comparable to transactions with an unaffiliated company.

(3) Extend credit or make any loan directly or indirectly to any company whose obligations are underwritten or distributed by the securities firm unless the securities are of investment quality.

(4) Extend credit or make any loan directly or indirectly to any investment company whose shares are underwritten or distributed by the securities company.

(5) Extend credit or make any loan where the purpose of the loan is to acquire securities underwritten or distributed by the securities company.

(6) Make any loans or extensions of credit to a subsidiary or affiliate of the bank that distributes or underwrites securities or advises an investment company in excess of the limits and restrictions set by section 23A of the Federal Reserve Act.

(7) Make any loan or extension of credit to any investment company for which the securities company acts as an investment advisor in excess of the limits and restrictions set by section 23A of the Federal Reserve Act.

(8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with the bank's securities company to underwrite or distribute the company's securities or condition a loan to a person on the requirement that the person purchase any security underwritten or distributed by the bank's securities company.

An insured nonmember bank is prohibited from becoming affiliated with any company that directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities unless: (1) The securities business of the affiliate is physically separate and distinct from the operation of the bank; (2) the bank and the affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither directors or officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities of the affiliate on the premises of the bank that involve customer contact; and (5) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank. The FDIC has chosen not to require notices relative to affiliates because we would normally find out in a deposit insurance application or a change of bank control notice.

The FDIC opinion has been consistent concerning the securities operations of bank subsidiaries and affiliates since the adoption of the above referenced regulation. The FDIC's position concerning direct securities activities is discussed more fully below.

Q.1.a. Has the FDIC permitted bank mutual fund sales and advisory services to be performed directly by state banks? Please explain what conditions and limitations have been imposed by FDIC on bank advisory services and sales and marketing of mutual funds and other noninsured investment products in order to eliminate consumer confusion, protect the safety and soundness of the bank and the Federal deposit insurance funds, and for the protection of investors, and how compliance with those conditions and limitations is implemented, examined for and enforced.

A.1.a. State nonmember banks engage in the sale of bank mutual funds and perform advisory services. The bank does not have to apply to the FDIC to engage in these activities; however, the activities are covered by the provisions of the "Statement on Retail Sales of Nondeposit Investment Products" issued by the bank and thrift regulatory agencies on February 15, 1994. It supersedes the FDIC's October 8, 1993 "Statement Regarding State Nonmember Bank Sales of Mutual Funds and Annuities."

This statement provides that the financial institution should adopt policies and procedures which address the risks associated with a sales program. The procedures that banks are expected to adopt should include making disclosures that the product is not insured by the FDIC, not a deposit or other obligation of, or guaranteed by, the depository institution, and subject to investment risks, including possible loss of the principal amount invested. Where applicable, the depository institution should disclose the existence of an advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution as well as the existence of any fees, penalties or surrender charges.

Because of the possibility of customer confusion, the guidelines indicate that a nondeposit investment product must not have a name that is identical to the name of the depository institution. Recommending or selling a nondeposit investment product with a name similar to that of the depository institution should only occur pursuant to a sales program designed to minimize the risk of customer confusion.

Sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products should be adequately trained with regard to specific products sold or recommended. These persons must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices.

Compliance with the guidelines and adherence to principles of safety and soundness are part of each regular annual examination of banks. The failure of a depository institution to establish

and observe appropriate policies and procedures consistent with the interagency statement and sound practice will be subject to examination criticism and appropriate corrective action. The FDIC has an array of such authorities, ranging from moral suasion to formal orders, removal of management, and money penalties.

Q.1.b. With specific reference to these examinations, do you examine merely for the existence of systems and records or do you utilize testers to ascertain actual compliance? Please provide copies of examination manuals pertaining to bank securities activities.

A.1.b. FDIC examinations of bank sales of nondeposit investment products focus on the bank's policies and procedures. To verify compliance with these policies and procedures, examiners have access to bank records and to the records needed to assess compliance by a third party vendor operating on the bank's premises.

The FDIC's Manual of Examination Policies contains examination guidelines on proper management, controls, capital, and audits to be followed in running a sound financial institution. The October 1993 FDIC statement and February 1994 interagency statement on sales of nondeposit investments constitute our specific examination guidance to examiners. Our 10-25-93 instructions to examiners (Regional Director Transmittal #93-154) constitute our specific directive to examiners on examination procedures. Copies of these three documents are attached. In addition, we will soon be distributing to our field staff copies of the recent best practices guidelines issued by the five trade associations. This publication offers considerable help in describing to examiners what to look for and at in examining a bank's sales of nondeposit instruments.

To this point, we have not utilized testers to check on bank practices in dealing with customers. Use of testers has been suggested in a variety of bank activities and is a matter always under consideration. While there clearly is some consumer misunderstanding about securities sales programs, our efforts at this time are concentrated on assuring documentation of original and continuing written disclosures, both at origination and ongoing during the life of the relationship.

Q.2. Please inform the Subcommittee of the current number and asset share of banks insured by the FDIC by type (e.g., national banks, state member banks, and state non-member banks) and total. Please identify the federal regulator for each category of institution. Please provide the Subcommittee with the number of FDIC-insured banks that are engaged directly in securities sales or advisory activities. Also, please provide the number of such banks engaged in such activities through bank operating subsidiaries, and through affiliates.

A.2. There are approximately 13,400 FDIC-insured depository institutions. Of this number, approximately 7,300 state-chartered banks that are not members of the Federal Reserve System are supervised by the FDIC, 1,700 thrifts are supervised by the Office of Thrift Supervision, 1,000 Federal Reserve System member banks by the Federal Reserve System and 3,400 national banks by the Office of Comptroller of the Currency. Of the approximately $4,600 billion in assets in FDIC-insured banks, 23 percent of this total is in banks supervised by the FDIC, 45 percent is in banks supervised by the Office of the Comptroller of the Currency, 17 percent in thrifts supervised by the Office of Thrift Supervision and 15 percent in banks supervised by the Federal Reserve System.

The FDIC is not able at this time to precisely state the number of banks and affiliates engaged in securities sales or advisory activities. Our regions indicate that one-third or more of state nonmember banks may be doing so. Changes to the bank Call Reports will allow collection of this information beginning with the reporting period ending March 31, 1994. Attached is a copy of the recently issued amended call report instructions. Beginning with the March 1994 Call Report, banks will report the amount of mutual funds and annuities they have sold, if any. There are 104 state nonmember banks that operate subsidiaries that engage in securities activities.

Q.3. **Both for (1) the insured depository institutions for whom FDIC is the federal regulator and (2) the insured depository institutions for whom FDIC is not the federal regulator, please advise the Subcommittee of the extent to which and the manner by which FDIC is informed and aware of the nature and extent of securities activities being conducted in such institutions and their affiliates, the existence of appropriate systems and controls, and actual compliance with relevant polices, procedures and laws and regulations. Please be specific. Do you examine for, and are you aware of, any customer complaints resulting from bank securities activities? Please provide details of any enforcement that the FDIC has brought relating to bank securities activities.**

A.3. There is no application or notice required of insured state nonmember banks before they engage in securities activities directly in a bank. Because securities activities of insured state nonmember banks conducted in a subsidiary of the bank may be more extensive than those permitted a national bank, the FDIC has had a regulation in place since 1984 which requires these institutions to notify the FDIC of planned securities activities. Our experience with these activities since the implementation of this regulation has been that banks subject to the regulation are in full compliance.

In October 1993, the FDIC issued a statement of supervisory concerns relating to sale of mutual funds and annuities. This statement of supervisory concerns was superseded by an inter-agency issuance relating to sales of nondeposit investment products in February 1994. Since the issuance of the original supervisory guidance, our examiners have become more focused on the issues relating to the sale of nondeposit investments. Our examination information to date indicates the industry has some work to do, particularly related to development of effective written policies and procedures relating to the sale of non-deposit products. We have found that although banks are attempting to address concerns, they have been slow to document their work in formal bank policies and procedures. For the most part, we believe bankers are sensitive to customer confusion issues and are attempting to differentiate between bank products and non-deposit investment products.

The FDIC has no aggregate data concerning the securities activities of insured institutions for which the FDIC is not primary supervisor. Data collection through changes to the bank Call Reports beginning March 31, 1994, should provide more information as to the extent of the activities for insured banks. Problems or concerns on individual institutions would be found in the individual files and reports on each institution.

We have polled our regional offices and our Office of Consumer Affairs and have found no customer complaints that have been filed regarding state nonmember bank securities activities. We recognize that certain surveys indicate significant customer confusion exists concerning these activities. We hope that measures we have already taken will reduce that confusion.

We have found that as our examiners find deficiencies in bank programs, management has been cooperative in making needed corrections immediately. Thus, the FDIC has had to take no formal enforcement actions to date concerning bank securities activities. Examiners are asking banks to improve disclosures and better document policies and procedures. One well publicized bank recently changed the name of its advised funds in order to avoid regulatory concern for confusion arising from similar names. In another case a knowledgeable customer complained to us that a bank employee was giving incorrect information on the insurance coverage for a nondeposit product. Working with the primary regulator of the bank, we were able to assure that the bank had proper policies in place and took steps to assure that the erring employee was corrected. We stand ready to use any enforcement tool at our disposal necessary to prevent abuses in a bank's securities program.

Q.4. Have any of the monies paid by FDIC to resolve failed institutions been paid to satisfy the claims of purchasers of investment products sold by such institutions? If so, please identify those matters.

A.4. The FDIC has not paid any monies to resolve failed institutions on investment products sold to customers that were not subsequently found to be deposits.

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FDIC
Federal Deposit Insurance Corporation
Division of Supervision
452 Fifth Avenue, 21st Floor, New York, New York 10018-2798

New York Regional Office

WILMINGTON TRUST C
SEP 4 1992
LEGAL DEPT.

September 2, 1992

Mr. Matthew Lynch
Assistant Vice President
Wilmington Trust Company
1100 North Market Street
Rodney Square North
Wilmington, Delaware 19890

Dear Mr. Lynch:

This will serve to confirm your conversation regarding mutual fund activities with Trust Specialist Richard P. Cinquina of my staff on August 27, 1992. The following representations have been made with respect to present and contemplated mutual fund activities of the bank and its affiliates:

(1) Wilmington Trust Company and Rodney Square Management Corporation currently serve as investment advisors to the Rodney Square Funds. These funds consist of seven money market, fixed income, and equity mutual funds having a current combined asset value of approximately 1.8 billion. The mutual funds are registered under the Investment Company Act of 1940.
(2) Wilmington Trust Company also performs back office work for the funds, including asset custodian, transfer agent, and shareholder servicer activities.
(3) The present distributor of the funds is Scudder Services, Inc., a non-affiliated mutual fund distributor.
(4) Wilmington Trust Company is the only subsidiary of Wilmington Trust Corporation, a registered bank holding company with the Federal Reserve.
(5) Rodney Square Management Corporation is a separately capitalized subsidiary of Wilmington Trust Company, and is a registered investment advisor under the Investment Advisors Act of 1940.
(6) Wilmington Brokerage Services Company, a separately capitalized subsidiary of Wilmington Trust Company, is a registered broker/dealer with the Securities and Exchange Commission, and a registered investment advisor under the Investment Advisors Act of 1940.
(7) Management intends to transfer the duties of mutual fund distributor from Scudder Services, Inc. to Wilmington Brokerage Services Company.
(8) The Federal Reserve has no objections to the transfer of mutual fund distribution activities to Wilmington Brokerage Services Company.
(9) Wilmington Trust Company will not invest employee benefit accounts administered by its trust department in the Rodney Square Funds; and will only invest discretionary personal accounts in the funds, if it first obtains written approval from customers holding authority to grant such approval.

Based upon the foregoing, this office has no objection to the transfer of duties of mutual fund distributor from Scudder Services, Inc. to Wilmington Brokerage Services Company.

Very truly yours,

Nicholas J. Ketcha Jr.
Regional Director

SCHEDULE RC-M – MEMORANDA

On the memoranda schedule, new item 12 has been added on the FFIEC 034 report forms, new item 9 has been added on the FFIEC 033 report forms, and new item 10 has been added on the FFIEC 031 and 032 report forms.

12. Mutual fund and annuity sales during the quarter (include proprietary, private label, and third party mutual funds):				
a. Money market funds	RCON 6441			12 a
b. Equity securities funds	RCON 6427			12 b
c. Debt securities funds	RCON 6428			12 c.
d. Other mutual funds	RCON 6429			12 d
e. Annuities	RCON 6430			12 e

Item 12 on the FFIEC 034, item 9 on the FFIEC 033, and item 10 on the FFIEC 031 and 032, Mutual fund and annuity sales (in domestic offices) during the quarter. Report in the appropriate subitem the amount of mutual fund and annuity sales (in domestic offices) during the quarter ending with the report date that were made directly by the reporting bank, through a bank subsidiary, and by affiliated[1] or unaffiliated entities with whom the bank has contractual sales arrangements. If sales are made by an entity that is located off-site and not on bank premises, the basis for the contractual agreement is that the entity is dependent on customer referrals from the bank and these referrals are the basis upon which the bank receives income or other benefits. When reporting sales by affiliated and unaffiliated entities, banks may rely on the sales information provided by these entities when completing this item.

In general, banks should include in the appropriate subitem initial purchases of mutual funds and annuities by bank customers and any subsequent sales to these customers for which the bank receives additional compensation. In general, subsequent sales to bank customers for which the bank receives no additional compensation should be excluded from this item. However, for those contractual sales arrangements with an affiliated or unaffiliated entity in which the bank's income consists solely of fees for space leased to this entity for its use in selling mutual funds and annuities (i.e., where the bank receives no fees or sales commissions in connection with the entity's sales of mutual funds and annuities), the bank should report those initial sales and any subsequent sales of mutual funds and annuities for which the affiliated or unaffiliated entity acknowledges the reporting bank to be the source of the referral leading to the sale. In addition, if the bank sweeps funds from customers' deposit accounts into money market funds and earns fees or sales commissions from the money market funds for these transactions, the bank should report the average amount of depositors' funds swept into money market funds each day during the quarter, <u>not</u> the total amount of depositors' funds swept into money market funds from deposit accounts each day during the quarter. The average may be computed from the amount of funds swept into money market funds for each day for the calendar quarter <u>or</u> from the amount of funds swept into money market funds on each Wednesday during the calendar quarter.

Mutual funds and annuities are investment products not covered by federal deposit insurance or other guarantees against loss. Banks should include sales of proprietary, private label, and third party mutual funds in this item. Both proprietary and private label mutual funds are established in order to

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[1] Other than a bank subsidiary.

be marketed almost exclusively to a bank's or banking organization's customers. In a proprietary mutual fund, the reporting bank or a subsidiary or other affiliate of the reporting bank acts as the fund's investment adviser. In a private label mutual fund, an unaffiliated entity acts as the fund's investment adviser. A third party mutual fund is generally widely marketed by numerous parties to the investing public, and an unaffiliated entity acts as the fund's investment adviser. An annuity is an investment product, normally issued by an insurance company, that guarantees either a fixed or variable payment stream over a specified period of time and, for tax purposes, generally allows the annuitant to recover the cost of the investment on a tax-free basis over the term of the annuity contract.

Item 12.a on the FFIEC 034, item 9.a on the FFIEC 033, and item 10.a on the FFIEC 031 and 032, Money market funds. Report the amount of sales (in domestic offices) during the quarter ending with the report date of mutual funds that, based on their investment objectives, can best be characterized as money market funds. Include sales that were made directly by the reporting bank, through a bank subsidiary, and by affiliated or unaffiliated entities with whom the bank has contractual sales arrangements. Money market funds are mutual funds which invest exclusively in short-term debt securities with the objective of maximizing current income while providing liquidity and preserving capital.

Item 12.b on the FFIEC 034, item 9.b on the FFIEC 033, and item 10.b on the FFIEC 031 and 032, Equity securities funds. Report the amount of sales (in domestic offices) during the quarter ending with the report date of mutual funds that, based on their investment objectives, can best be characterized as equity securities funds. Include sales that were made directly by the reporting bank, through a bank subsidiary, and by affiliated or unaffiliated entities with whom the bank has contractual sales arrangements. Equity securities funds are mutual funds that invest primarily in equity securities (e.g., common stock).

Item 12.c on the FFIEC 034, item 9.c on the FFIEC 033, and item 10.c on the FFIEC 031 and 032, Debt securities funds. Report the amount of sales (in domestic offices) during the quarter ending with the report date of mutual funds that, based on their investment objectives, can best be characterized as debt securities funds. Include sales that were made directly by the reporting bank, through a bank subsidiary, and by affiliate or unaffiliated entities with whom the bank has contractual sales arrangements. Debt securities funds are mutual funds that invest primarily in debt securities (e.g., corporate bonds, U.S. Government securities, municipal securities, mortgage-backed securities).

Item 12.d on the FFIEC 034, item 9.d on the FFIEC 033, and item 10.d on the FFIEC 031 and 032, Other mutual funds. Report the amount of sales (in domestic offices) during the quarter ending with the report date of mutual funds that, based on their investment objectives, cannot properly be reported in one of the three preceding items. Include sales that were made directly by the reporting bank, through a bank subsidiary, and by affiliated or unaffiliated entities with whom the bank has contractual sales arrangements. Other funds may include mutual funds that invest in a mix of debt and equity securities.

Item 12.e on the FFIEC 034, item 9.e on the FFIEC 033, and item 10.e on the FFIEC 031 and 032, Annuities. Report the amount of sales (in domestic offices) during the quarter ending with the report date of annuities. Include sales that were made directly by the reporting bank, through a bank subsidiary, and by affiliated or unaffiliated entities with whom the bank has contractual sales arrangements.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Director
Division of Supervision

FIL-71-93
October 8, 1993

SALES OF NONDEPOSIT INVESTMENTS

TO: CHIEF EXECUTIVE OFFICER

SUBJECT: Supervisory Statement Regarding State Nonmember Bank Sales of Mutual Funds and Annuities

The FDIC's Division of Supervision has developed the attached supervisory statement to alert state nonmember banks to concerns and issues raised by bank sales of mutual funds and annuities, which are investment products not covered by federal deposit insurance or other guarantees against loss. One such concern is the potential for customer confusion if a bank offers nondeposit investments at the same location where FDIC-insured deposits are solicited. Another is the potential for mismanagement of the sales program, which could expose the bank to liability under the anti-fraud provisions of federal securities laws.

For further information, please contact Curtis L. Vaughn, an Examination Specialist in the FDIC's Division of Supervision (202-898-6759) or Ann Loikow, a Counsel in the FDIC's Legal Division (202-898-3796).

Stanley J. Poling
Stanley J. Poling
Director

Attachment

Distribution: FDIC-Supervised Banks (Commercial and Savings)

FDIC Supervisory Statement on State Nonmember Bank Sales of Mutual Funds and Annuities

Background

Banks increasingly are involved in the sales of mutual funds and annuities in response to changing customer needs and in an attempt to retain customer relationships while increasing noninterest income. Such activities include sales made directly by a bank, through a bank subsidiary or affiliate, or by an unaffiliated entity whether located on bank premises or located off-site but dependent on customer referrals from which the bank receives a benefit. Securities activities of subsidiaries or affiliates of insured state nonmember banks are governed by section 337.4 of the FDIC's Rules and Regulations.

The purpose of this statement is to alert state nonmember banks of prominent safety and soundness concerns and other possible issues from the sales of these two products. Two principal concerns are: (1) potential customer confusion over the nature of products offered and (2) the potential for mismanagement of the sales programs for these alternative investment products, which could expose a bank to liability under the anti-fraud provisions of federal securities laws.

Adoption of Control Procedures

Bank management should implement control procedures to guard against these risks, including development of written policies and procedures governing the bank's involvement in these activities.

Every state nonmember bank engaging in mutual fund and annuity sales should develop policies that at a minimum address the concerns highlighted in this statement. The policies should be reviewed and approved by the bank's board of directors prior to the bank's engaging in a sales program for these investment products. Senior bank management should closely supervise the operation of the bank's mutual fund and annuity sales program to ensure compliance with the bank's policies and procedures.

The bank also should have a compliance and audit program, independent of the sales program, to monitor the bank's mutual funds and annuity sales activities. Consistent with any audit or compliance function, findings should be periodically reported directly to the bank's board of directors, or a designated committee of the board. The bank should ensure that applicable laws, rules and regulations governing the sales of securities, annuities and other nondeposit investments are observed to minimize the risk of possible liability of the bank. Therefore, banks are encouraged to consult with legal counsel when designing and implementing sales programs for mutual funds and annuities.

Customer Confusion

Customer confusion may result if a bank offers nondeposit investments on bank premises in a manner similar to that in which deposits are solicited. Therefore, mutual funds and annuities should be promoted and sold, and the bank's sales activities administered, in a manner that clearly distinguishes such instruments from FDIC-insured deposits.

Banks also should recognize the potential for customer confusion if nondeposit investments are offered at the same physical locations where deposits are accepted, or if such investments are offered by bank employees who also accept deposits.

The FDIC addressed this concern in section 337.4 of the FDIC's rules and regulations in the context of securities activities conducted by subsidiaries or affiliates of state nonmember banks. Section 337.4 requires that securities activities of insured nonmember bank subsidiaries and bank transactions with affiliated securities companies be conducted in physically separate and distinct locations to minimize the potential for customer confusion. The area in which mutual funds and annuities are sold should be clearly and prominently identified to distinguish such activities from traditional deposit-taking activities of the bank.

Tellers or other bank employees involved in deposit-taking activities generally should be prohibited from selling investment products and from offering investment advice. Good practice would suggest that their involvement be limited to informing customers of the availability of investment alternatives through bank-offered mutual funds or annuities and directing interested customers to qualified personnel for more specific information. If bank employees are also representing third-party vendors, they should clearly inform customers when they are also acting on behalf of the third party.

Disclosure

Appropriate disclosures to customers interested in nondeposit investment alternatives are necessary to prevent misleading customers about the nature of the investments. The disclosures should specify that mutual funds and annuities are not bank deposits, are not insured by the FDIC, and are not guaranteed by, or obligations of, the bank.

The investment risks of the instruments also should be disclosed, including the potential for fluctuations in investment return and the possibility of loss of some or all of the principal investment. Disclosures should be made in oral sales presentations and in writing before any investment decision is made and an account is opened. Banks should consider requiring customers to sign an acknowledgement when a mutual fund or annuity account is opened to confirm that the customer received and understands the disclosures.

Banks should take appropriate steps to ensure that all advertisements and promotions for mutual funds and annuities are accurate and not misleading, and include the disclosures described above. In particular, confusion may arise from jointly advertising or marketing deposits and nondeposit investments, or from including information about the nondeposit investments in customer deposit account statements. Therefore, any joint advertising or combined account information should clearly segregate information regarding FDIC-insured deposits from information on nondeposit investments, and should include a prominently displayed disclosure statement as described above.

Customer confusion also may arise from the use of names for nondeposit investments that are similar to the bank's name. In most instances, the disclosures described above should be sufficient to permit customers to distinguish between bank deposits and investment products such as mutual funds and annuities.

If a bank or its affiliate serves as adviser to mutual funds offered by the bank, written disclosures should be made to customers of the bank's advisory role. The disclosures should reemphasize that the bank does not guarantee the fund, nor do mutual fund shares constitute obligations of the bank.

Management and Administration of Sales Programs

Apart from potential liability arising from customer confusion over the differences between insured deposits and mutual fund or annuity investments, banks that participate in sales of nondeposit investments may be liable to customers, shareholders, or others for the management of these activities. The FDIC is concerned that banks properly administer these activities to protect themselves from liability that may affect the bank's overall safety and soundness.

Written policies and procedures should address the selection criteria for nondeposit investments to be offered, the use of bank customer information for marketing purposes, and the administration and supervision of the sales program, including review procedures for ensuring compliance with these policies and procedures by third parties offering nondeposit investments on bank premises.

Customers purchasing mutual funds and annuities from banks are likely to assume that the bank has exercised some degree of financial expertise in choosing products to offer. Bank policies should establish qualitative standards for the selection and marketing of products the bank will offer. Part of the process for selecting products to be offered should include due diligence reviews of third parties with whom the bank is considering entering into arrangements or whose products the bank may offer. Reviews should be conducted prior to entering into any agreements and periodically during the term of the bank's relationship with the third party.

Arrangements for offering investment products through third parties should be in writing and include terms regarding compensation for bank space, equipment and personnel used by the third party. The written arrangements also should impose responsibility on the third party to comply with bank policies governing the activities and identify the responsibility of bank management to review compliance by the third party. All arrangements should be reviewed and approved by the bank's board of directors prior to the bank's engaging in the activities.

Bank management should be mindful of the potential for confusion when developing policies governing the permissibility of the use of bank customer information for marketing purposes. Marketing efforts which have targeted customers with maturing certificates of deposit can lead to abuse and therefore are of special concern to the FDIC. Banks allowing such targeted marketing should take precautions to ensure that customers are fully informed about, and understand the nature of, mutual fund and annuity investments as opposed to insured deposits.

Qualifications and Training

Banks have responsibility for ensuring that sales personnel are properly qualified and trained to sell the nondeposit investments offered. This includes ensuring that sales personnel meet applicable statutory and industry requirements and standards for licensing and registration. Training should emphasize thorough product knowledge and customer protection requirements. Employees should know the difference between coverage provided through the Securities Investor Protection Corporation (SIPC) and through FDIC deposit insurance, and should help customers understand this difference, if applicable. Additionally, training should be provided to all bank employees who have direct customer contact to ensure a basic understanding of the nature of products offered by the bank, and the bank's policy for limiting the involvement of employees taking deposits in the sales of nondeposit products. Bank compliance and audit staff also should be appropriately trained.

Customer Suitability

If the bank recommends nondeposit investment products to customers, appropriate documentation should be maintained to reflect that the salesperson had reasonable grounds to believe the recommended investment was suitable for the customer at the time of the transaction. This requires that sales representatives make reasonable inquiry into a customer's financial condition and background, tax status and investment objectives in order to make the suitability determination.

Documentation of the inquiry should be maintained in customer files and based on information obtained directly from the customer. The files should be updated periodically.

Other Issues

Compensation programs based on sales volume present potential conflicts of interest. The bank's policies and procedures should address compensation arrangements and how to prevent them from operating as an incentive for salespeople to sell nondeposit investments over a more suitable alternative. Employee referral programs, if allowed by bank policy, should be based solely on the referral and not whether the referral resulted in a sale.

Potential conflicts of interest may arise from the use of bank distribution arrangements to facilitate fiduciary account investments administered by the bank's trust department. Sales of mutual funds and annuities to related trust department accounts should be allowed only if they are consistent with the bank's obligations as a fiduciary and meet the criteria of the bank's policies governing trust documents and applicable law. If sales to the bank's own trust accounts are allowed, regular reviews should be conducted to ensure that the sales do not violate the bank's fiduciary obligations and constitute permitted and suitable investments for the particular trust.

Prior to embarking on a sales program for mutual funds and annuities, banks should notify their blanket bond carriers of plans to engage in these activities and the specifics of their arrangements. Written assurance should be obtained from the carrier that the bank's insurance coverage for employees includes staff representing third-party vendors.

Supervisory Policy

As part of regular safety and soundness examinations, FDIC examiners will review bank policies and procedures governing sales of mutual funds and annuities as well as management's implementation of and compliance with them. Reviews will focus on the adequacy of measures taken to inform customers of the differences between nondeposit investment alternatives and bank deposits, and the administration of nondeposit investment sales programs to guard against possible liability stemming from bank involvement in these activities. Failure of banks to establish and observe appropriate policies and procedures for mutual fund and annuity sales programs will be subject to criticism and required corrective action.

(September 29, 1993)

Division of Supervision MEMORANDUM SYSTEM	CLASSIFICATION NUMBER 6610(S) DATE: October 25, 1993 ISSUING OFFICE: OP/PPD CONTACT: C. Vaughn 86759 ☐ NOTICE ☒ MEMORANDUM

MEMORANDUM TO: Regional Directors

FROM: Stanley J. Poling
Director

SUBJECT: Participation of State Nonmember Banks in the Sales of Mutual Funds and Annuities

1. Purpose. To establish examination procedures for state nonmember banks that participate in the sales of mutual funds and annuities.

2. Background. Bank involvement in the sale of nondeposit investments in recent years has expanded from the trust department into retail sales of these investments. Primary emphasis has been on mutual funds and annuities, products previously handled by securities brokers and insurance agents.

Participation directly by the bank in the sale of securities may be conducted in several forms. A bank may act as sales agent, merely giving customers access to various mutual fund or annuity products. If more specific products are desired, the bank may contract with a specific organization to provide a professional distribution system. Often third party vendors are employed to operate on the bank premises or bank employees become dual employees of the bank and the broker/dealer. Sometimes a bank may become involved with an affiliated broker/dealer.

The highest level of involvement is usually limited to larger banks who contract with an unaffiliated party to become the distributer of a "private label" mutual fund. These funds are typically advised or administered by the bank and sometimes carry a name similar to the bank, hence the reference to a proprietary fund. The distributer performs those functions that are prohibited for a bank under Federal law. These proprietary products are created typically to generate fee income beyond that available from acting solely in an agency capacity in the sale of fund shares.

3. Action Required. The FDIC Division of Supervision has issued guidance concerning the sales of mutual funds and annuities which alerts State nonmember banks to certain prominent safety and soundness concerns. (See FIL 71-93, 10-8-93). Examiners should familiarize themselves with the provisions of the statement and use the guidance contained therein in reviewing a bank's involvement in the sale of mutual funds or annuities.

Transmittal # 93-154

Examiners are reminded that the guidance in the supervisory statement applies to bank sales of nondeposit investments. Securities activities of subsidiaries or affiliates are governed by the provisions of section 337.4 of the FDIC's regulations. The guidance contained herein is not intended to replace existing examination procedures relating to bank trust activities or municipal securities dealers activities. Also, banks involved in the sales of mutual funds or other securities must comply with the provisions of Part 344 relating to recordkeeping and confirmation requirements for securities transactions. Typically in third party arrangements, the bank can depend on its agent to keep records regarding transactions, send confirmations to customers, etc. A participating bank may only have to disclose to customers the remuneration it receives in connection with the securities transaction, and even that obligation may be discharged if the confirmation contains the relevant information.

As a general principal, examiners should review the policies and procedures adopted by the bank rather than the records of the broker/dealer. FDIC responsibility is to assure that the bank has considered areas of potential concern and has taken steps to mitigate those concerns. The FDIC does not wish to become involved in areas already supervised under other Federal regulatory schemes.

The guidance is intended to alert banks to areas of supervisory concern. Banks may address these concerns in any manner that effectively lessens customer confusion and assures proper management of the sales program of nondeposit investments.

The statement attempts to balance the need for supervisory guidance on the sale of nondeposit investments with the realization that size, personnel and resource limitations may affect the manner in which a bank responds to the guidance. For instance, the supervisory statement states that tellers or other bank employees involved in deposit-taking activities generally should be prohibited from selling investment products and offering investment advice. In smaller banks or branches, if this guidance is interpreted narrowly, these institutions may be blocked from participating in the activity. If it is unavoidable for an employee to act in this dual capacity, examiners should review other controls in place such as physical separation of deposit-taking and investment activities and the efforts made by the employee to inform the customer when they are acting on behalf of a third party vendor.

Compensation programs may be structured in many different ways, but these programs are most likely to present conflicts of interest when compensation is based solely on sales volume. When reviewing compensation programs, concerns should focus on whether the customer is being directed into investments based on fees offered the employee. Sales programs that focus on customer

needs reduce the potential conflicts of interest inherent in some compensation programs.

As part of the usual examination program, examiners should review a bank's policies and procedures governing sales of mutual funds and annuities and analyze management's implementation and compliance with these policies and procedures. Significant deficiencies found should be commented on in the Report of Examination (normally in the Administration, Supervision and Control section and Conclusions page, if appropriate) and corrective action should be recommended commensurate with the severity of the deficiency. The supervisory statement contains the Division's views on the standards for safe and sound participation in sales of nondeposit investments. Because this activity is still somewhat new and not universally seen, it is appropriate for reports to contain a brief descriptive statement of the nature and extent of a bank's involvement in this activity.

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 2, 1994

The Honorable Andrew C. Hove
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Chairman Hove:

Pursuant to Rules X and XI of the Rules of the U.S. House of Representatives, and our continuing oversight of securities and exchanges, we are investigating the facts and circumstances surrounding the proposed merger between the Dreyfus Corporation (Dreyfus) and Mellon Bank Corporation (MBC) whereby Dreyfus will be acquired by Mellon Bank, N.A. (Mellon Bank) as a separate operating subsidiary.

In connection with the Subcommittee hearings today and tomorrow on this matter, serious concerns have been raised regarding the adequacy of the protections that the banking laws afford customers who purchase securities or investment advice in banks. Accordingly, I am transmitting the enclosed 55-page draft table comparison of the regulation of broker-dealers and investment advisers under the federal securities laws versus under the federal banking laws. The table summarizes the principal relevant statutes, regulations, and guidelines administered by the Securities and Exchange Commission and by the federal banking agencies. The Subcommittee will be keeping the hearing record open for 30 days to accommodate our request that you carefully review this document and submit any corrections you deem necessary to make this table accurate and complete.

If you have any questions about this request, please contact Consuela M. Washington of the staff at (202) 225-3147. Thank you for your cooperation and assistance with the work of the Subcommittee.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

Enclosure

cc: The Honorable Dan Schaefer

ROOM 2323
RAYBURN HOUSE OFFICE BUILDING
PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

March 31, 1994

The Honorable Andrew C. Hove
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Chairman Hove:

This is with reference to the Subcommittee's letter of March 2, 1994 asking you to review our draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and under the federal banking laws. The table does not include all the federal securities laws and rules, nor does it address the regulation of banks as transfer agents, municipal, or government securities dealers. This is consistent with the scope of the Subcommittee's inquiry as well as the table's stated scope.

At the request of the Office of the Comptroller of the Currency, we are extending the deadline for your responses to the close of business on Friday, April 8, 1994, at which time we will be closing the hearing record and taking the steps to go to prompt printing. It would be helpful if the recipients of the March 2 letter would meet and discuss (and where possible coordinate) your responses. In any event, your transmittal letters for your corrections should indicate the name and phone number of a contact person on your staff, in the event that we have questions about your submission.

The Subcommittee greatly appreciates your cooperation and assistance with our work. We firmly believe that these issues are of vital importance to the protection of the public.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer
The Honorable Alan Greenspan
The Honorable Arthur Levitt
The Honorable Eugene A. Ludwig

ONE HUNDRED THIRD CONGRESS

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PHONE (202) 225-4441

U.S. House of Representatives
Subcommittee on Oversight and Investigations
of the
Committee on Energy and Commerce
Washington, DC 20515-6116

May 10, 1994

The Honorable Andrew C. Hove
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Chairman Hove:

This is in reference to your letter of April 8, 1994 and enclosure commenting on our draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and the federal banking laws.

To the extent that your comments suggest substantive corrections, we are making the necessary revisions to the final table and greatly appreciate your assistance. In some cases, however, your comments raise points that are already noted in the table or are beyond its scope.

In connection with our review of the FDIC's comments, the Subcommittee respectfully requests your responses to the following by the close of business on Friday, May 20, 1994 so that we may complete our edits to the comparison table:

1. At various places, the FDIC cites fiduciary requirements as providing customer protection to investors who purchase securities through banks. For example, the FDIC's comments note (in connection with suitability requirements applicable to bank brokerage activities) that "fundamental principles of fiduciary law require that banks exercising fiduciary powers recommend or invest in only those securities that are suitable for the beneficiaries of any particular account." (FDIC Comments at 15; <u>see also id</u>. at 16 (Chinese walls), and at 18 (private rights of action).)

The Subcommittee has researched the matter, but has not learned of any instance in which the federal banking regulators determined that bank brokerage activities require approval as fiduciary activities subject to fiduciary law requirements. Moreover, we are not aware of any regulatory requirement that a

customer enter into a trust agreement with a bank prior to brokerage services being made available. We therefore request that you provide citations to any such rulings.

2. Your letter cites two FDIC proceedings, First County Bank, Stamford, Connecticut and In the Matter of Robert J. Aulie, Brooklyn Savings Bank, Danielson, Connecticut, as examples of the FDIC's use of 12 C.F.R. § 1818 to reach violations of the antifraud provisions of the federal securities laws.

As you noted, the FDIC and SEC acted jointly in bringing the Aulie case. According to the SEC's Litigation Release, the SEC and FDIC charged that Aulie violated Exchange Act Section 10(b) and Rule 10b-5 thereunder, and aided and abetted violations of Exchange Act Section 13(a) and FDIC Rule 330. SEC and FDIC v. Aulie, SEC Litigation Release 12899 (July 9, 1991). Specifically, the agencies alleged that Brooklyn Savings Bank and Aulie failed to maintain adequate loan loss allowances, and that by materially understating such allowances, the bank and Aulie materially overstated the bank's new income in financial reports for two fiscal quarters.

The facts of the First County Bank case are less clear. The FDIC comments state only that "[v]iolations of section 15(c) of the Exchange Act are referenced in the body of the order, and the cessation of such violations are ordered." (FDIC Comments at 13) The FDIC's order in the case simply directed the bank to eliminate and/or correct all remediable violations of "the Department of Treasury regulations enforcing Section 15(c) of the Securities and Exchange Act of 1934." On the basis of the order and its description in the FDIC comments, however, we cannot determine what charges the FDIC brought against First County Bank.[1]

Accordingly, we request that you provide the Subcommittee with a copy of the record in the FDIC's First County Bank case. With respect to the Aulie case, we request that you provide internal FDIC materials sufficient that the Subcommittee can determine the basis on which the FDIC brought its portion of the case. In addition, please explain whether the FDIC, acting independently (rather than jointly with the SEC), would have had jurisdiction to bring charges based on violations of Section

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[1] As an initial matter, we are not aware of any Treasury Department regulations implementing Section 15(c). Exchange Act Section 15C, a provision governing government securities brokers and dealers, is of course another matter. The Treasury Department has rulemaking authority under Section 15C, and the FDIC is identified as the "appropriate regulatory agency" for government securities brokers and dealers that are insured nonmember banks.

The Honorable Andrew C. Hove, Jr.
Page 3

10(b) and Rule 10b-5, or whether the FDIC would have been limited to alleging violations of Section 13(a) and FDIC Rule 330.

Thank you for your cooperation and attention to this request.

Sincerely,

John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations

cc: The Honorable Dan Schaefer

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

94 MAY 24 AM 9 32

May 23, 1994

Honorable John D. Dingell
Chairman
Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your letter in response to the Federal Deposit Insurance Corporation's review and comments upon a draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and the federal banking laws.

Your letter requested that we provide you with additional information in response to two questions. Enclosed you will find a response to those questions prepared by FDIC staff.

If you or your staff have any further questions, our Office of Legislative Affairs can be reached at 898-8730.

Sincerely,

Andrew C. Hove

Andrew C. Hove, Jr.
Acting Chairman

Enclosure

STAFF RESPONSE TO LETTER FROM HONORABLE JOHN D. DINGELL, REQUESTING ADDITIONAL INFORMATION CONCERNING FDIC'S COMMENTS ON COMPARISON OF REGULATION OF BROKER-DEALERS AND INVESTMENT ADVISERS UNDER FEDERAL SECURITIES LAWS AND FEDERAL BANKING LAWS

The following responds to a letter dated May 10, 1994 from the Honorable John D. Dingell, requesting additional information concerning the FDIC's comments on the Subcommittee's draft table comparing the regulation of broker-dealers and investment advisers under the federal securities laws and the federal banking laws. This memorandum has been written to respond to the questions in the order in which they were raised in the letter.

1. The letter seems to indicate that the FDIC's comments referencing state fiduciary law imply that bank brokerage activities require prior approval as fiduciary activities. The FDIC's comments were not intended to imply that a fiduciary license or trust agreement is required before a bank may offer brokerage activities generally to its customers. Rather, the comments simply reflect the fact that securities brokerage and investment advisory activities have for many years been conducted within bank trust departments on behalf of customers with whom the bank has a fiduciary relationship. Where such a fiduciary relationship exists, securities activities conducted through bank trust departments are subject to the fiduciary duties and remedies pursuant to fiduciary law (both as codified and as developed in caselaw) in addition to the various provisions of the federal securities laws that apply to bank trust departments.[1] Thus, fiduciary customers have always been able to resort to state fiduciary law for redress, for example, for improper investment of fiduciary assets, or the breach of the duties of loyalty, to exercise reasonable care and skill, to keep and render accounts, to furnish information, or to keep fiduciary property separate, etc.[2]

2. The letter also raised questions concerning <u>First County Bank, Stamford, Connecticut</u> and <u>In the Matter of Robert J. Aulie, Brooklyn Savings Bank, Danielson, Connecticut.</u> These proceedings are discussed more specifically below. In addition, the letter inquired whether the FDIC, as a general matter, has the authority to independently prosecute violations of the antifraud provisions of federal securities laws.

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[1] These include sections 10(b), 13(d), 13(f), 14(b), 17(f), and 17A of the Securities Exchange Act of 1934, SEC rules governing privately placed securities, the Trust Indenture Act of 1939 and the Investment Company Act of 1940 as applicable.

[2] <u>See generally</u>, A. Scott & W. Fratcher, The Law of Trusts §§ 169-185 (Duties of the Trustee) (4th ed. 1987).

Although the Federal Deposit Insurance Act (the "FDI Act") does not contain language expressly prohibiting fraud in connection with securities activities, the jurisdiction of the FDIC is not so narrowly limited. Under section 8 of the FDI Act, 12 U.S.C. § 1818, the FDIC is empowered to prosecute by means of a broad range of actions,[3] any unsafe or unsound banking practices as well as violations of any laws, rules or regulations. Virtually every fraudulent activity violates some law or regulation and, therefore, comes within the scope of the FDIC's enforcement powers. In addition, any fraud committed with respect to an insured depository institution is, by its nature, an unsafe or unsound activity and also comes within the FDIC's jurisdiction to prosecute.

Where another law enforcement entity (such as the SEC or the U.S. Attorney's office) is involved, the FDIC makes every effort to coordinate enforcement and prosecutorial efforts with the other involved law enforcement entity in the interest of avoiding double jeopardy,[4] res judicata, or equitable estoppel problems in the proceeding. The FDIC has found that such cooperative efforts from all parties results in the most efficient use of law enforcement resources and powers and affords maximum protection to the industry. The involvement of another agency does not, however, prevent the FDIC from proceeding pursuant to its own enforcement authority even if the other agency decides not to prosecute. For example, in the case of embezzlement by a bank employee, the U.S. Attorney's Office may decide for a variety of reasons not to prosecute.[5] That decision does not preclude the FDIC from bringing an enforcement action against the employee. On several occasions the FDIC has done just that, issuing a section 8(e) removal order against individuals barring them from participating in the affairs of any insured depository institution.

The Aulie case, in which the SEC and FDIC joined in seeking an injunction pursuant to section 10(b) and 13(a) of the Securities and Exchange Act of 1934 ("Exchange Act"), is an example of such cooperative enforcement efforts. Mr. Aulie also

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[3]The types of actions the FDIC is empowered to take include cease and desist orders, suspension, removal or prohibition proceedings, and civil money penalties.

[4]See U.S. v. Halper, 109 S.Ct. 1892, 490 U.S. 435 (1989).

[5]We have observed several factors which seem to affect this decision including (i) the dollar amount involved (which can vary substantially from jurisdiction to jurisdiction), (ii) restitution by the individual or others, or (iii) limited resources on the part of the U.S. Attorney's office.

stipulated to a section 8(e) prohibition order whereby, based on his involvement in the violations of federal securities laws, he agreed to a lifetime ban on future participation in the banking industry. These orders were sought concurrently with his stipulation to the joint federal court injunction. Copies of the letter forwarding the section 8(e) stipulation and order to Mr. Aulie, the signed stipulation and order of prohibition, as well as the federal injunction, are attached. Also attached are several news articles which pertain to the Aulie case.

The basis for both the joint action and the section 8(e) order against Mr. Aulie was his submission to the FDIC of false reports under section 13 of the Exchange Act. The facts are as follows:

Robert J. Aulie was the former president, chief executive officer and director of Brooklyn Savings Bank, Danielson, Connecticut (the "Bank"). While at the Bank, Aulie was primarily responsible for the Bank submitting to the FDIC two Quarterly Reports ("Form F-4") under Section 13 of the Securities Exchange Act of 1934 ("Exchange Act") for quarters ending June, 1989 and September, 1989 which materially overstated the overall financial condition of the Bank. Apparently the misrepresentations came about as the result of understating the Bank's allowance for loan losses, when Aulie knew or should have known that the Bank was on the verge of experiencing serious losses due to the Bank's involvement in loan(s) to a foundering real estate development project known as the "Thermos on the Thames" project ("Thermos project").

Mr. Aulie participated in making statements in the June, 1989 F-4 which painted the progress of the Thermos project in an extremely rosy light, when in fact at the time of the statements, the project had experienced several construction delays, sales were substantially behind projections, and extraordinary sales incentives (an unlimited buy-back guarantee by the Bank) were not bringing in results. In addition to the foregoing, by the time of the September, 1989 F-4, the project had already defaulted on a $1.8 million loan, a fact which was not mentioned in the F-4. Also, the September, 1989 F-4 indicated that sales in the project were going very well, when in fact sales drastically lagged behind internal projections. Mr. Aulie's signature appeared on both F-4's in question, and the facts seemed to indicate that he knew or should have known that the two F-4's contained false and misleading information.

The SEC and FDIC joined in seeking the injunction pursuant to the antifraud provisions of section 10(b) of the Exchange Act, and pursuant to section 13(a) of the Exchange Act. The FDIC's participation in the proceedings was necessary to lend impact to the action, since the false filings were made with the FDIC. Absent SEC participation, however, the FDIC would not have been

precluded from citing a violation of section 10(b) and Rule 10b-5 as part of the section 8 enforcement action, or as the basis for other injunctive relief.

With respect to the First County case, copies of the stipulation and consent to the issuance of an order to cease and desist as well as the order itself are attached. The order at page 22 requires the bank to "eliminate and/or correct all remediable violations of Federal Reserve Board Regulation O and the Department of the Treasury regulations enforcing Section 15(c) of the Securities and Exchange Act of 1934." Although section 15(c) is referenced in the order, because of the citation to Department of Treasury regulations, it is very possible that what was intended to be referenced in the order was the cessation of violations of Department of Treasury regulations under section 15C of the Exchange Act. However, because this action was stipulated to without requiring issuance of a notice of charges and because it was issued pursuant to delegated authority at the Regional Office level, we are unable to state with certainty which section of the Exchange Act is the correct reference. Nonetheless, the order clearly addressed violations of federal securities laws.

Attachments

REGULATION OF BROKER-DEALERS AND INVESTMENT ADVISERS

The following table (which is preceded by a summary table) compares the regulation of broker-dealers and investment advisers under federal securities laws and under federal banking laws. The table demonstrates the difference in focus between the two regulatory schemes and highlights the need for legislation -- such as H.R. 3447 -- to provide for the functional regulation of all securities activities. The table illustrates that, under current law, banks that engage directly in securities brokerage and advisory activities are outside the regulatory framework established under the federal securities laws, and are not subject to comparable, uniform or enforceable standards under federal banking laws.

Part I of the table notes that banks that engage directly in securities activities are exempt from broker-dealer regulation under the federal securities laws. Consequently, banks and bank employees are not subject to direct Commission oversight, or to any but the antifraud provisions of the federal securities laws. The securities activities of banks and their personnel are governed by federal banking laws, which, with the exception of limited recordkeeping and confirmation requirements, do not specifically address direct bank brokerage activities. Rather, the securities regulatory programs of the federal banking agencies are primarily based on guidelines that define general standards and give the banks wide latitude to establish policies and procedures to implement those standards. Notably, there are questions regarding the enforceability of the standards by the federal banking agencies or bank customers.

The table describes several critical areas where federal banking law differs substantially from the federal securities laws. For example, federal banking law does not require banks to register as broker-dealers or provide notice of securities activities to their banking regulator. Bank employees who sell securities are not subject to uniform testing and qualification requirements prior to engaging in direct securities activities. Moreover, federal banking law does not include procedures for the screening of bank securities salespersons for prior violations of law. Also notable is the fact that, under federal banking law, there is no particular provision imposing sanctions on banks for failure to adequately supervise their employees engaged in securities activities. Federal banking law does not generally contain private rights of action for investors and there is no banking law counterpart to the securities arbitration scheme for bank securities investors. The table also notes that bank examinations under the federal banking law focus primarily on bank safety and soundness and only secondarily on compliance with the federal securities laws.

Part II of the table describes the regulatory gaps that arise under the federal banking laws respecting bank investment adviser activities. Banks engaging in investment advisory activities are subject to a regulatory scheme that includes notice to the appropriate federal banking regulator, fiduciary standards and recordkeeping requirements. However, because bank advisers are not required to register with the Commission as investment advisers, Commission examiners who inspect bank-advised investment companies have no express authority to examine the bank adviser's books and records relating to clients other than the investment company. As a result, a bank adviser to an investment company is not subject to an examination that focuses on the evaluation of potential conflicts of interest between the bank investment adviser and the investment company.

REGULATION OF BROKER-DEALERS AND INVESTMENT ADVISERS

The following table compares the regulation of broker-dealers and investment advisers under federal securities laws and under federal banking laws. The table demonstrates the difference in focus between the two regulatory schemes and highlights the need for legislation to provide for the functional regulation of all securities activities. This table is a summary of a fuller version.

I. BROKER-DEALERS

A. REGISTRATION

- Broker-dealers must register with the Commission under federal securities laws. Broker-dealers and their associated persons must register with a SRO.

B. TESTING AND QUALIFICATIONS

- Broker-dealers and their associated persons are subject to uniform, comprehensive testing and qualification requirements and procedures.

1. Statutory Disqualifications

- Individuals subject to statutory disqualifications may be excluded by the Commission from employment with broker-dealers in order to protect investors.

2. Fingerprinting

- Broker-dealers and their associated persons engaged in the sale of securities must be fingerprinted for processing by the U.S. Attorney General.

3. Fidelity Bonds

- Broker-dealers are required to maintain fidelity bonds.

C. ANTIFRAUD

- Broker-dealers and their associated persons are subject to federal securities laws antifraud provisions, including Commission rules that are intended to prohibit and prevent market manipulation and deceptive and fraudulent practices and conduct.

D. SALES PRACTICE RULES

- Broker-dealers and their associated persons must comply with Commission and SRO sales practice rules, particularly those relating to suitability and excessive prices.

I. BANKS

A. REGISTRATION

- Banks do not have to register as broker-dealers or provide notice of securities activities under the federal banking laws. Banks and bank employees who sell securities are not members of a SRO.

B. TESTING AND QUALIFICATIONS

- Bank employees who sell securities are not subject to uniform testing and qualification requirements and procedures. Federal banking statutes and regulations contain no provisions governing sales training and qualification.

1. Statutory Disqualifications

- Bank employees convicted of a broad range of violations may be barred from participating in any manner in the conduct of an FDIC-insured bank's affairs unless approved by the FDIC.

2. Fingerprinting

- Bank employees engaged in the sale of securities to bank customers are not required to be fingerprinted under federal banking laws.

3. Fidelity Bonds

- Banks are required to maintain bond coverage.

C. ANTIFRAUD

- The federal banking statutes do not include provisions expressly prohibiting fraud in connection with bank securities activities. However, banks and bank employees who sell securities are subject to certain of the federal securities laws antifraud provisions, including Commission rules that are intended to prohibit market manipulation and deceptive and fraudulent practices and conduct.

D. SALES PRACTICE RULES

- Federal banking regulations do not include provisions for suitability requirements or other sales practice rules designed to protect investors who purchase securities through banks. Bank employees

1. Suitability

• Broker-dealers generally are required to "know their security" and "know their customer" when recommending securities products to customers.

2. Excessive prices; sales commissions and mark-ups

• Broker-dealers are subject to Commission and SRO rules prohibiting the charging of excessive prices and commissions.

E. DUTY TO SUPERVISE

• Broker-dealers are subject to sanctions for failure to adequately supervise their employees. Broker-dealers are also subject to controlling person liability for employees who engage in violations of the federal securities laws.

1. Chinese Walls

• Broker-dealers must establish internal policies and procedures to restrict the flow and prevent the misuse of material nonpublic information.

F. DISCIPLINARY PROCEEDINGS

• Broker-dealers are subject to disciplinary sanctions ranging from censure to revocation of their registration if they engage in activities that violate the federal securities laws, the rules adopted thereunder, or SRO rules. Public releases describe the nature of the proceedings and the identity of parties disciplined.

1. Investor Actions

• The federal securities laws have been interpreted to confer private rights of action to investors for certain violations of the federal securities laws, including the major antifraud provisions. In addition, SRO rules require broker-dealers to resolve disputes with their customers in industry-sponsored arbitration forums that are subject to Commission oversight.

who sell securities are not subject to Commission and SRO sales practice rules.

1. Suitability

• The federal banking statutes and regulations do not require banks to evaluate the suitability of investments recommended to customers.

2. Excessive prices; sales commissions and mark-ups

• Federal banking law prohibits as an unsafe and unsound practice excessive compensation or compensation that could result in a material financial loss to a bank. Federal banking statutes and regulations do not establish specific compensation requirements and procedures for bank employees, including employees effecting securities transactions for bank customers. Nor do they address mark-ups by bank employees for effecting securities transactions.

E. DUTY TO SUPERVISE

• There is no particular provision in federal banking law imposing sanctions on banks for failure to adequately supervise their employees engaged in securities activities.

1. Chinese Walls

• Banks are required under the federal banking laws to establish and maintain policies and procedures providing for the disclosure of the securities activity of bank personnel who are involved in investment recommendations; however, the federal banking laws do not comprehensively address conflict of interest issues.

F. DISCIPLINARY PROCEEDINGS

• Banks and bank-related parties are subject to disciplinary sanctions ranging from censure to removal if they engage in unsafe and unsound practices or violations of laws, regulations or supervisory agreements. Public releases of the proceedings do not describe the nature of the proceedings.

1. Investor Actions

• Federal banking laws do not generally contain private rights of action for investors and there is no banking law counterpart to the securities arbitration scheme for bank securities investors.

G. FINANCIAL RESPONSIBILITY

• Broker-dealers are required to meet net capital and other operational and financial competence standards established by the Commission to protect the customers and creditors of broker-dealers.

1. Net Capital Rule

• Broker-dealers must meet certain basic financial responsibility standards to assure that customers can recover their funds and securities in the event the broker-dealers become insolvent.

2. Customer Protection Rule

• Broker-dealers are required to maintain sufficient funds to assure that their customers can recover those funds in the event the broker-dealers become insolvent.

3. Risk Assessment

• Broker-dealers are subject to risk assessment recordkeeping and reporting requirements with respect to activities engaged in by their affiliates.

4. Limitations on Extensions of Credit

• The extension of credit by broker-dealers to their customers is limited.

H. RECORDKEEPING AND CONFIRMATIONS

• Broker-dealers are subject to comprehensive recordkeeping and reporting requirements for securities transactions.

2. Confirmations

• Broker-dealers are required to provide customers with written, detailed information on securities transactions effected for their customers.

3. Lost and Stolen Securities

• Broker-dealers must report lost or stolen securities to the Commission or its designee and, in some cases, to the Federal Bureau of Investigation ("FBI").

G. FINANCIAL RESPONSIBILITY

• Bank regulatory agencies require that banks and bank holding companies maintain certain levels of capital. These capital rules, however, are not specifically designed with securities activities in mind.

1. Net Capital Rule

• Banks are not required under the federal banking laws to satisfy specific capital requirements in order to engage in securities activities. Bank securities operations are not subject to the net capital requirements developed for the protection of broker-dealer customers.

2. Customer Protection Rule

• Banks are not required to maintain sufficient funds to assure that their securities customers can recover those funds in the event the banks become insolvent.

3. Risk Assessment

• Bank holding companies are subject to detailed recordkeeping and reporting requirements but such requirements are not focused on securities activities engaged in by affiliates.

4. Limitations on Extensions of Credit

• Limitations on extension of credit by banks to their securities customers are less restrictive than limitations imposed on broker-dealers.

H. RECORDKEEPING AND CONFIRMATIONS

• Federal banking regulators have adopted only limited recordkeeping and confirmation requirements for securities transactions.

2. Confirmations

• Regulations of the federal banking agencies require banks to provide customers with limited written information on securities transactions effected for their customers.

3. Lost and Stolen Securities

• Banks must report lost or stolen securities to the Commission's designee, the SIC, and to the FBI.

J. INSOLVENCY PROTECTION

• Broker-dealers must contribute to an industry-wide fund to protect their securities customers in the event the broker-dealers become insolvent.

J. INSOLVENCY PROTECTION

• Bank brokerage customers are not protected by SIPC insurance. In the event of a bank failure, however, bank brokerage customers are protected by FDIC insurance with respect to cash arising from securities transactions that is held in deposit accounts (up to $100,000). Securities held in safekeeping are returned to the owners.

K. EXAMINATIONS

• Broker-dealers are examined by the Commission and their DEA to assure compliance with the federal securities laws, Commission and SRO rules.

K. EXAMINATIONS

• Banks are examined to assure the appropriate federal banking regulator that the overall financial condition of the bank is safe and sound. Bank examinations are not focused upon banks' compliance with federal securities laws.

II. <u>INVESTMENT ADVISERS</u>

A. REGISTRATION

• Federal securities law requires investment advisers to register with the Commission.

B. CUSTOMER DISCLOSURES

• Investment advisers must disclose certain information to both the Commission and States and to their customers, and subsequently are required to take additional steps to keep their registrations in good standing.

C. FIDUCIARY DUTIES

• Registered investment advisers are subject to certain fiduciary standards.

1. <u>Compensation</u>

• The IAA prohibits registered advisers from collecting "performance fees" based on the success of their investment advice, with certain exceptions.

2. <u>Agency Cross and Principal Transactions</u>

• Registered advisers are prohibited from acting as broker or principal in buying or selling securities from a client.

3. <u>Antifraud Provision</u>

• The IAA imposes certain antifraud requirements on registered advisers.

II. <u>BANK INVESTMENT ADVISERS</u>

A. REGISTRATION

• Under federal banking law, banks do not have to register as investment advisers. However, banks do have to provide general notice to the appropriate federal banking regulator regarding their investment advisory activities.

B. CUSTOMER DISCLOSURES

• Federal banking regulations require banks and bank holding companies acting as investment advisers to make certain disclosures to bank investment advisory customers.

C. FIDUCIARY DUTIES

• Under federal banking law, banks acting as investment advisers are subject to certain fiduciary standards.

1. <u>Compensation</u>

• Federal banking law generally does not put limits on the kinds of fees bank advisers may charge.

2. <u>Agency Cross and Principal Transactions</u>

• Federal banking law does not expressly prohibit bank advisers from acting as broker or principal in buying or selling securities from a client. However, general principles of fiduciary law require bank fiduciaries to maintain undivided loyalty to the client and to avoid conflicts of interest. Moreover, banking regulations contain some guidelines regarding transactions to avoid so as to generally prevent conflicts of interest.

3. <u>Antifraud Provision</u>

• The federal banking statutes do not include provisions expressly prohibiting fraud in connection with bank investment advisory activities. However,

a. Advertising

• Registered investment advisers are prohibited from engaging in false advertising.

b. Custody of Client Assets

• Registered advisers who have custody of the funds or securities of their clients are subject to heightened requirements with respect to steps they must take to ensure the safety of the funds or securities, and disclosures they must make.

c. Solicitations

• Registered advisers must comply with certain requirements when paying someone to solicit business.

d. Financial and Disciplinary Disclosures

• As noted above, registered advisers have a duty to disclose to their clients precarious financial conditions and prior disciplinary actions.

4. Duty to Supervise

• Registered advisers have a duty to supervise.

5. Chinese Walls

• Registered advisers are required to maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the advisers or their associated persons.

D. RECORDKEEPING REQUIREMENTS

• Registered investment advisers are required to maintain certain kinds of books and records respecting their investment advisory activities.

E. EXAMINATIONS

• Registered investment advisers are subject to both routine and cause inspections of their investment advisory activities.

banks and bank employees who provide investment advice are subject to the antifraud provisions of the Exchange Act (Section 10(b) and Rule 10b-5 thereunder).

a. Advertising

• Federal banking regulations contain only limited restraints on the kinds of advertising permitted for banks engaging in investment advisory activities.

b. Custody of Assets

• Bank investment advisers with custody of client funds or securities are not subject to uniform requirements with respect to steps they must take to ensure the safety of the funds or securities, or disclosures they must make.

c. Solicitations

• Federal banking regulations do not contain provisions for bank advisers that pay someone to solicit business.

d. Financial and Disciplinary Disclosures

• Under federal banking law, bank advisers do not have a specific duty to disclose to their customers precarious financial conditions or prior material legal or disciplinary actions.

4. Duty to Supervise

• Federal banking law does not impose on bank advisers an express duty to supervise or responsibility for persons acting on their behalf. (See additional discussion of this issue generally, supra, under I.E.)

5. Chinese Walls

• National banks are required to adopt written policies and procedures to prevent the misuse of material inside information by their trust departments.

D. RECORDKEEPING REQUIREMENTS

• Federal banking law does not generally require bank investment advisers to keep particular records respecting their investment advisory activities.

E. EXAMINATIONS

• Although bank fiduciary activities are subject to examinations by the federal bank regulators, bank investment advisory activities with respect to advising a registered investment company are not subject to the same kinds of examinations that registered investment advisers are subject to. For example, a bank adviser to a mutual fund is not subject to an examination that focuses on the evaluation of potential conflicts of

interest between the adviser and the investment company. Bank examinations' primary focus is on whether the overall financial condition of the bank is safe and sound.

F. ENFORCEMENT ACTIONS

- The Commission may bring a civil injunctive action against any person for violations of the IAA or any regulation thereunder. The Commission may bring an administrative proceeding against any investment adviser and its associated persons for violations of the federal securities laws and regulations thereunder, and for committing certain acts enumerated in the IAA. The Commission may seek money penalties in both the civil and administrative context, and may impose both temporary and permanent cease-and-desist administrative orders.

F. ENFORCEMENT ACTIONS

- The federal banking regulators may bring administrative proceedings against banks and bank-related parties for engaging in unsafe and unsound practices or violations of laws, regulations or supervisory agreements. The banking regulators may seek civil money penalties, and may impose both temporary and permanent cease-and-desist orders.

SPECIAL REQUIREMENTS FOR INVESTMENT ADVISERS TO REGISTERED INVESTMENT COMPANIES

- The 1940 Act contains certain requirements applicable to investment advisers to investment companies, including mutual funds, as described below. These requirements are in addition to the regulations applicable to registered investment advisers under the IAA.

SPECIAL REQUIREMENTS FOR INVESTMENT ADVISERS TO REGISTERED INVESTMENT COMPANIES

- While banks and bank holding companies are specifically excluded from the IAA's definition of investment adviser, banks and bank holding companies are not excluded from the 1940 Act's definition of investment adviser, and are therefore subject to requirements applicable to investment advisers to mutual funds under the 1940 Act. The 1940 Act's definition of affiliated person includes any investment adviser to a mutual fund, so banks are also subject to the 1940 Act's provisions for affiliated persons. Banks are therefore subject to the provisions of the 1940 Act (described at left) in the investment advisers column of this chart. Comparable banking regulations, if any, are discussed, supra, in the sections noted below.

G. INVESTMENT ADVISORY CONTRACT

- Investment advisers to investment companies are required to have a contract with the investment company, which must contain certain terms, including the amount of compensation.

G. INVESTMENT ADVISORY CONTRACT

- Federal banking law does not require a bank acting as investment adviser to a mutual fund to have an investment advisory contract with the fund.

H. FIDUCIARY DUTIES

- The 1940 Act imposes fiduciary duties on investment advisers to mutual funds.

H. FIDUCIARY DUTIES

- As noted above, under federal banking law, banks acting as investment advisers to investment companies are subject to certain fiduciary standards.

I. RECORDKEEPING REQUIREMENTS

- Investment advisers to registered investment companies are required to maintain certain books and records.

I. RECORDKEEPING REQUIREMENTS

- As noted above, bank investment advisers are generally not required by federal banking law to keep particular records respecting their investment advisory activities.

REGULATION OF BROKER-DEALERS AND INVESTMENT ADVISERS

The table below summarizes the principal statutes, regulations, and guidelines governing broker-dealers and investment advisers administered by the Commission and by the federal banking agencies (the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Federal Reserve Board).

The scope of this table is limited to bank-related brokerage activity that occurs in an entity that is not subject to the regulatory scheme of the federal securities laws. Accordingly, the table is not intended to cover broker-dealer affiliates of banks, bank holding companies or foreign banking institutions that are required to register with the Commission. The table also does not apply to bank municipal and government securities activities.

Federal Securities Laws

The Securities Exchange Act of 1934 ("Exchange Act"), and the rules thereunder, establish a comprehensive scheme for registering broker-dealers and regulating their activities. The regulatory scheme under federal securities laws for broker-dealers is grounded in concepts of market integrity and investor protection. The Commission achieves the regulatory scheme of the federal securities laws by enforcing requirements that include: registration with the Commission and a self-regulatory organization ("SRO"); compliance with competency, financial responsibility, recordkeeping and reporting requirements; adherence to Commission and SRO sales practice rules and specialized antifraud rules; and the provision of insolvency protection for investors. Broker-dealers are also subject to Commission and SRO examination and oversight.

The regulatory scheme for broker-dealers under federal securities laws includes the following major components:

Federal Banking Laws

Federal banking laws and regulations do not establish a comprehensive regulatory scheme for banks engaged in securities activities. Regulation of bank brokerage activity by the federal banking agencies is structured on guidelines that provide the banking institutions with discretionary authority to establish and implement policies and procedures. Moreover, the regulatory scheme under federal banking laws for banks' securities activities is grounded in concepts of depositor protection and preservation of the safety and soundness of the banking system. Toward this end, the federal banking agencies' regulatory approach focuses on the overall operations, activities, and management of the regulated financial institutions to assure their financial integrity and, thereby, to achieve customer protection of investors who purchase securities through banks. The federal banking agencies rely on their examination authority as a supervisory tool to assure banks' compliance with agency guidelines and applicable banking and securities laws, rules and regulations.

Recently, the federal banking agencies issued an Interagency Statement to provide "uniform guidance" to banks that sell mutual funds, annuities, and other nondeposit investments. The statement apparently supersedes prior separate guidelines that were issued by the banking agencies. Thus, the OCC's Banking Circular 274, Retail Nondeposit Investment Sales, was rescinded and replaced by new section 413 to the

Comptroller's Handbook for National Bank Examiners ("Comptroller's Handbook"). (See OCC Bulletin 94-13, February 24, 1994) Section 413 provides national bank examiners with guidance for examining mutual fund or other retail nondeposit investments sales operations of national banks. The guidance implements and incorporates the Interagency Statement.

The guidelines set forth in the Interagency Statement apply to sales made by bank employees; sales made by employees of affiliated or unaffiliated entities on the bank's premises; and sales resulting from customer referrals when the bank receives a benefit for the referral. The guidelines do not establish clear and uniform standards of conduct for banks engaged directly in securities activities. The guidelines are general in nature and provide the banks with wide latitude to establish policies and procedures to implement them. Notably, the guidelines are not regulations. As "guidelines," they are not legally enforceable by the banking agencies or bank customers. (See Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994))

The regulatory scheme under federal banking laws for banks engaged in securities activities includes the following major components:

I. **BROKER-DEALERS**	I. **BANKS**
A. **REGISTRATION**	A. **REGISTRATION**
● Broker-dealers must register with the Commission under federal securities laws.	**● Banks do not have to register as broker-dealers or provide notice of securities activities under the federal banking laws.**

1. Registration with the Commission

Section 15(a) of the Exchange Act generally makes it unlawful for a broker or dealer to engage in securities business on an interstate basis unless it registers with the Commission. Form BD is the form filed by a securities firm required to register with the Commission as a broker-dealer under the Exchange Act (§ 15(b)).

Under §§ 3(a)(4) and (5) of the Exchange Act, banks are excluded from the definitions of "broker" and "dealer" and, therefore, are outside of the broker-dealer regulatory scheme of the federal securities laws. However, the bank exclusion only extends to banks. It does not apply to broker-dealer subsidiaries or affiliates of banks, bank holding companies or foreign banking institutions that are required to register with the Commission. Moreover, banks that engage in municipal and government securities business are subject to the regulatory schemes for government and municipal securities brokers and dealers imposed under the federal securities laws.

1. Registration with the Federal Banking Regulators

Banks generally are required to register with respect to their overall banking activities. For example, national banks are chartered by the OCC and may only engage in activities that are within or incidental to the business of banking or otherwise authorized by statute, and are consistent with principles of safety and soundness. However, there are no specific requirements in the federal banking statutes that banks provide notice of their participation in securities activities to their appropriate federal banking regulator.

It is noted that the FDIC recently published changes to Call Reports filed quarterly by insured state nonmember commercial and savings banks. The revisions, scheduled to be effective as of March 31, 1994, would include a requirement that the banks provide data on mutual fund and annuity sales. The OCC and the Federal Reserve Board are making the same changes to the Call Reports filed by the banks under their supervision. (See 59 FR 2603, January 18, 1994) Notably, the FDIC's publication does not state the manner in which banks would provide mutual fund and annuity data under the Call Report revisions, e.g., under combined or separate categories.

2. Membership in an SRO

● **Broker-dealers and their associated persons must register with a SRO.**

In addition to registration with the Commission, § 15(b)(8) of the

2. Membership in an SRO

● **Banks and bank employees who sell securities are not members of a SRO.**

Because only registered broker-dealers and their associated

Exchange Act requires a broker-dealer to become a member of a SRO. Also, individuals who work for, or are "associated" with a broker-dealer firm must be registered with their broker-dealer firm's SRO by filing Form U-4. Section 3(a)(18) of the Exchange Act defines "associated persons of a broker or dealer" as any partner, officer, director, branch manager, or employee of a broker-dealer, or any person controlled by, controlling, or under common control with the broker-dealer.

SRO rules regulate the professional conduct of their members, and include many provisions designed to prevent fraudulent and manipulative practices and to promote just and equitable principles of trade (Exchange Act §§ 6(b)(5) and 15A(b)(6)). The SROs have adopted a substantial body of rules of conduct for their broker-dealer members.

Generally, SRO rules fall into two categories: rules relating to transactions on the particular market and rules relating to the internal operations of the member broker-dealer firms and their dealings with their customers. Due to space constraints, this table will only include several of the most important SRO rules.

The SROs also have authority to examine their members, investigate complaints against members, conduct disciplinary proceedings, and impose penalties for violations of their own rules and the federal securities laws. (See NASD Rules of Fair Practice, Art. V, §1)

Under § 19 of the Exchange Act, the SROs have broad authority to adopt, administer, and enforce

persons can be members of a SRO, banks and their employees who sell securities are not eligible to be members of a SRO. Banks and their associated persons are not subject to a SRO's rules of professional conduct based on just and equitable principles of trade, which are designed to prevent fraudulent and manipulative securities practices.

rules subject to the oversight of the Commission. The SROs' rules are subject to Commission review and approval (§ 19(b)); the Commission also may abrogate or amend the SROs' rules to meet the Exchange Act's standards (§ 19(c)). In addition to its ability to approve or disapprove changes in SRO rules, or to amend them, the Commission oversees the self-regulatory responsibilities of registered SROs through the registration process, its ability to sanction SROs for failure to comply with their legal obligations (§ 19(h)), and through routine examinations of the SROs (§ 17(b)).

B. **TESTING AND QUALIFICATIONS**

- **Broker-dealers and their associated persons are subject to uniform, comprehensive testing and qualification requirements and procedures.**

1. Competency and Testing Requirements

Section 15(b)(7) of the Exchange Act empowers the Commission to devise and administer tests and to require registered broker-dealers and associated persons to pass uniform, comprehensive competency tests administered by a SRO. Section 15(b)(7) also authorizes the Commission to enforce qualification standards and to prohibit broker-dealers from engaging in securities transactions unless their associated persons meet SRO qualification standards.

The Commission's authority under § 15(b)(7) of the Exchange Act is implemented by Commission Rule 15b7-1, which requires registered

B. **TESTING AND QUALIFICATIONS**

- **Bank employees who sell securities are not subject to uniform testing and qualification requirements and procedures. Federal banking statutes and regulations contain no provisions governing sales training and qualification.**

1. Competency and Testing Requirements

No federal banking regulator administers and devises competency tests for bank employees who sell securities. Nor is there mandated uniformity among tests established by the banking industry.

The Interagency Statement of the federal banking agencies does not establish uniform testing and qualification requirements and procedures, but instead charges each bank with developing its own program. The guidelines state that the bank's policies and procedures should include a "description" of the training required for employees authorized to sell investment products and

broker-dealers and their associated persons to comply with qualification standards established under the rules of a SRO of which the broker-dealer is a member or to which it is subject.

Current competency tests have been devised by the SROs in consultation with the Commission, and are subject to Commission oversight. Generally, the SROs require an individual to pass a comprehensive, uniform test relating to the securities products that the individual will sell, or the position of responsibility that the individual will occupy, at the broker-dealer firm. For example, the NASD qualifications system includes the following tests:

- Series 7 (GS) - General Securities Representative
- Series 8 (SU) - General Securities Sales Supervisor
- Series 24 (GP) - General Securities Principal
- Series 27 (FN) - Financial and Operations Principal

Recently, the SROs announced a plan to develop a single continuing education program for all securities industry registered representatives and principals. (See 7 NASD Regulatory & Compliance Alert, No. 1 (March 1993))

those personnel having contact with customers concerning the bank's sales program. Banks are directed to ensure that employees selling investments or providing investment advice are "adequately trained" with regard to the products being sold or recommended. Supervisory personnel should receive "training appropriate to that position." Training should be updated periodically and occur on an ongoing basis.

The guidelines state that training for employees who sell investments should be the "substantive equivalent" of that required for personnel qualified to sell securities as registered representatives. However, it is not clear which SRO qualification standards the banking agencies want bank management to incorporate to ensure that sales personnel are properly qualified and "adequately trained" to sell all bank-related nondeposit investment products. Moreover, it is noted that bank employees are not eligible to take SRO competency examinations unless they are affiliated with a broker-dealer.

Section 413 of the Comptroller's Handbook advises examiners that a bank's hiring practices and training plan should be designed around the complexity and risks of the particular investment products being offered. Therefore, "[w]hile it may be appropriate to have a banking generalist with no securities industry background sell money market mutual funds, it could be inappropriate to allow this individual to sell fixed-rate annuities without extensive training." (See OCC Bulletin 94-13 at 9)

2. Statutory Disqualifications

• Individuals subject to statutory disqualifications may be excluded by the Commission from employment with broker-dealers in order to protect investors.

Registered broker-dealers and their associated persons can be excluded from securities activities or employment if they are subject to certain statutory disqualifications set forth in section 3(a)(39) of the Exchange Act, which are designed to prevent persons with an adverse disciplinary history from becoming, or becoming associated with, registered broker-dealers.

Broker-dealers are required under federal securities laws to fully disclose their disciplinary histories to the Commission and a SRO and to undergo a background check to determine whether they are subject to statutory disqualification from membership in an SRO.

The National Association of Securities Dealers ("NASD"), under the Commission's oversight, has established a testing and qualification scheme for broker-dealer personnel that includes a Central Registration Depository ("CRD") system to register such personnel, and background checks of broker-dealer personnel to ensure that they are not subject to statutory disqualifications.

Section 3(a)(39) of the Exchange Act defines the term "statutory disqualification." A person generally is subject to a statutory disqualification if that person has been convicted of any felony or certain enumerated misdemeanors within the last ten years; is enjoined temporarily or

2. Statutory Disqualifications

• Bank employees convicted of a broad range of violations may be barred from participating in any manner in the conduct of an FDIC-insured bank's affairs unless approved by the FDIC.

Sections 1818(e) and 1829 of Title 12 are the only provisions in federal banking law applicable to bank employees analogous to the statutory disqualification provisions (Sections 3(a)(39), 15(b)(4) and 15(b)(6) of the Exchange Act) under federal securities law.

Under 12 U.S.C. § 1818(e), bank regulators have broad powers of administrative removal and prohibition with respect to bank employees, officers, and directors. Under 12 U.S.C. § 1829, persons convicted of a range of criminal offenses involving dishonesty or a breach of trust may be barred from participating in any manner in the conduct of the affairs of an FDIC-insured bank without the written consent of the FDIC.

12 U.S.C. § 1829 covers a broader range of violations than is covered in the statutory disqualification provisions of the federal securities law, and reaches convictions beyond the 10-year time frame established under the federal securities laws. No FDIC action is required to establish a disqualification under 12 U.S.C. § 1829: the burden is on the applicant to demonstrate that an exception should be made in his or her case.

An individual subject to a removal/prohibition order under 12 U.S.C. § 1818(e) is barred from participating in the conduct

permanently from violating the securities laws by a court of competent jurisdiction, or has been and is barred or suspended from association with a broker-dealer by the Commission, a SRO or the foreign equivalent thereof.

Those persons who are statutorily disqualified, but wish to enter or re-enter the industry, must apply to the SRO under procedures adopted pursuant to Commission Rule 19h-1. The Commission has authority to review the SRO's judgment. If the SRO decides to permit a statutorily disqualified person to associate with a broker-dealer under appropriate special supervisory conditions, the Commission may authorize such employment or issue an order that directs the SRO to bar the proposed employment.

of a bank's affairs for life, absent written approvals from the agency that issued the order and the agency that is the bank's primary federal banking regulator. The grounds for removal under 12 U.S.C. § 1818(e) are not limited to banking related activities; they include activities occurring at any business institution that involve violations of law, breach of fiduciary duty, and/or unsafe and unsound practices.

12 U.S.C. § 78 provides that no employee of a corporation and no individual primarily engaged in underwriting securities shall serve at the same time as an officer, director or employee of a member bank unless the Federal Reserve Board determines that the investment policies of the member bank or the advice it gives its customers would not be unduly influenced. Notably, the provision would not be violated by service of officers of the member bank's trust department as officers of an investment fund operated by the bank. (See Investment Co. Institute v. Camp, 401 U.S. 617 (1971))

Federal banking law does not require that bank employees apply to the federal banking regulators in order to engage in the sale of securities products. Federal banking law does not establish a registration system comparable to the CRD system for broker-dealer personnel under the federal securities laws.

The Interagency Statement of the federal banking agencies recommends that bank management investigate the background of employees hired for their nondeposit investment products sales programs. The investigation should include

checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience. However, the guidelines do not say what banks must do if employees have a disciplinary history; nor do broker-dealer statutory disqualifications apply to bank employees.

3. Fingerprinting

● **Broker-dealers and their associated persons engaged in the sale of securities must be fingerprinted for processing by the U.S. Attorney General.**

As an additional tool to enhance investor protection by ensuring adequate competency among securities personnel, the Commission promulgated Rule 17f-2.

Rule 17f-2 provides that broker-dealers must require that each of its partners, directors, officers and employees be fingerprinted and must submit, or cause to be submitted, the fingerprinting to the U.S. Attorney General, or its designee, for identification and appropriate processing, unless the individual is not engaged in the sale of securities; has no supervisory authority; and has limited access to the firm's securities.

3. Fingerprinting

● **Bank employees engaged in the sale of securities to bank customers are not required to be fingerprinted under federal banking laws.**

There is no federal banking statute that expressly requires banks to fingerprint present or prospective employees. Nor has 12 U.S.C. § 1829 been interpreted as including such a requirement. Moreover, the FDIC has noted that the federal preemption doctrine applies to fingerprinting; that only banks whose personnel are required to be fingerprinted under Commission Rule 17f-2 (12 C.F.R. § 240.17f-2) (i.e., New York banks which are registered transfer securities agents) can impose such a requirement if state law prohibits fingerprinting. (See 1990 FDIC Interp. Ltr. LEXIS 79, February 28, 1990)

Federal banking law requires banks and bank holding companies to file notice with the appropriate federal banking regulator 30 days prior to adding or replacing directors; employing senior executive officers; or changing the responsibilities of individuals from one senior executive position to another. (12 U.S.C. § 1831i)

Under § 1831i, the notice must include information pertaining to the identity, personal history, business background and experience of a proposed director or senior executive officer, including pending legal or administrative proceedings to which the individual is a party and any criminal indictment or conviction.

The OCC's regulation implementing § 1831i requires national banks, within certain categories, to file notices with the OCC prior to changes in their directors and senior executive officers. (12 C.F.R. § 5.51) The OCC has stated that the 30-day prior notice includes a requirement that fingerprints be submitted for FBI review unless within three years prior to a filing an individual has previously submitted fingerprints under a § 1831i notice. (See Banking Bulletin 93-28, May 28, 1993)

Notably, the OCC's fingerprinting requirement only applies to bank directors and senior executive officers. It does not apply to lower level employees, in particular it may not apply to bank employees engaged in the sale of securities. Moreover, the OCC's fingerprinting requirement is not grounded on protecting the securities customer. Under the regulation, the OCC's disapproval of a proposed director or senior executive officer is determined on the basis of whether the individual's competence, experience, character or integrity would be "in the best interests of the depositors of the bank or [] of the public." (12 C.F.R. § 5.51(e)(2))

4. Fidelity Bonds

4. Fidelity Bonds

● **Broker-dealers are required to maintain fidelity bonds.**

Broker-dealers are required by rules of the SROs to maintain blanket fidelity bonds insuring against a variety of risks, including loss through any dishonest or fraudulent act of any employee, loss of property through robbery, burglary, larceny, theft, false pretenses, or misplacement while within the office or premises of the insured, loss of property in transit, forgery, securities loss (including securities forgery) and fraudulent trading. The limits of coverage vary, depending upon the net capital requirement of the broker-dealer. (NASD Rules, art. III, § 32; NYSE Rule 319; American Stock Exchange Rule 330)

● **Banks are required to maintain bond coverage.**

Banks generally are required by law or by agency supervision to maintain a Banker's Blanket Bond, which affords coverage similar to the Stockbroker's Blanket Bond.

Officers and employees of national banks must have adequate fidelity bond coverage, and the failure of directors to require bonds with adequate sureties and in sufficient amounts may make them liable for any losses which the bank sustains because of the absence of such bonds. (12 § C.F.R. 7.5215) While there are no specified limits of coverage for national banks, bank examiners rely upon suggested limits of the American Bankers Association ("ABA") in reviewing a national bank's fidelity bond coverage.

Section 413 of the Comptroller's Handbook advises examiners that banks proposing to engage in nondeposit investment sales programs may consider notifying their blanket bond carriers in order to obtain written assurances from the carrier that the bank's insurance coverage for employees includes staff representing third party vendors. (See OCC Bulletin 94-13, p. 2)

The FDIC has authority to require any FDIC-insured bank to provide protection and indemnity against burglary, defalcation, and other similar insurable losses. If an insured bank refuses to comply with any such requirement, the FDIC may contract for such protection and indemnity and add the cost to the assessment otherwise payable by the bank. (12 U.S.C. § 1828(e)) There are no FDIC regulations enforcing a bonding requirement nor is there

a requirement that a bank notify the FDIC when its fidelity bond has been terminated. However, guidelines are provided for FDIC examiners to assure that insured banks carry a minimum blanket bond coverage consistent with the ABA's recommended coverage.

C. **ANTIFRAUD**

- **Broker-dealers and their associated persons are subject to federal securities laws antifraud provisions, including Commission rules that are intended to prohibit and prevent market manipulation and deceptive and fraudulent practices and conduct.**

There are three major antifraud provisions contained in the Federal securities laws:

Section 17(a) of the Securities Act of 1933 prohibits fraud in connection with sales of securities by any person, including registered broker-dealers, banks, and others.

Section 10(b) of the Exchange Act provides the Commission with broad powers to proscribe fraud that occurs in connection with the purchase and sale of securities by any person, including registered broker-dealers, banks, and others. The statute applies to all securities, both listed and OTC securities.

Commission Rule 10b-5 is the basic regulation implementing §10(b) of the Exchange Act. Courts have ruled that investors have an implied private right of action under Rule 10b-5.

Section 15(c) of the Exchange Act prohibits manipulative, deceptive, or fraudulent conduct by broker-dealers in transactions

C. **ANTIFRAUD**

- **The federal banking statutes do not include provisions expressly prohibiting fraud in connection with bank securities activities. However, banks and bank employees who sell securities are subject to certain of the federal securities laws antifraud provisions, including Commission rules that are intended to prohibit market manipulation and deceptive and fraudulent practices and conduct.**

Under 12 U.S.C. §1818, the federal banking regulators can bring administrative proceedings against banks and bank-related parties for unsafe and unsound practices that pose a financial threat to the bank, or for violations of laws, regulations, or supervisory agreements.

It is not clear, however, that this provision gives the federal banking regulators a means of enforcing the antifraud provisions of the federal securities laws. Congressional intent behind § 1818 was to provide the banking agencies with improved means of discharging their **existing** responsibilities. There is no evidence that Congress considered enforcement of the antifraud provisions part of those existing responsibilities. Furthermore, courts have limited the use of § 1818 when another statute specifically provides a separate enforcement mechanism -- as do

involving the purchase or sale of securities in the OTC market, and gives the Commission express authority to define and take measures to prevent such conduct. The provision applies only to registered broker-dealers.

Through interpretation and enforcement of the antifraud provisions contained in the federal securities laws, the Commission has articulated a broker-dealer duty of fair dealing toward customers. The "shingle theory" holds that a broker-dealer impliedly represents to its customers that it will deal fairly with them. This duty encompasses, inter alia: the best execution of customer orders, disclosure of all material information, fair pricing, and full disclosure of any conflicts of interest. Broker-dealer actions or representations inconsistent with the implied representation of fair dealing may constitute actionable fraud under the antifraud provisions of the federal securities laws.

The Commission has brought actions under the antifraud provisions against a wide range of abuses, including:

- misrepresentations and omissions in offering materials and financial statements
- insider trading
- market manipulation
- churning
- unauthorized trading
- unsuitable recommendations
- excessive markups
- misuse of funds and of customers' securities

the federal securities laws, with respect to the enforcement of the antifraud provisions. Finally, no litigated court cases have been found in which the federal banking regulators invoked § 1818 to reach violations of the antifraud provisions of the federal securities laws (although it appears that there may be one settled case that followed Commission action. See In the Matter of Thelma Elizabeth Pollard (OCC EA No. 625 (1992)).

Authorities generally agree that authority to enforce the antifraud provisions of the federal securities laws rests with the Commission rather than the federal banking agencies, even with respect to institutions covered by Section 12(i) of the Exchange Act (which vests the federal banking regulators with jurisdiction over periodic and financial reporting by publicly owned banks and thrifts). See 4 L. Loss & J. Seligman, Securities Regulation 1772 (3d ed. 1990); 1 M. Malloy, The Corporate Law of Banks 492, 525-56 (1988); SEC v. Warner, 652 F. Supp. 647 (S.D. Fla. 1987). The Warner court, for example, noted that "[c]onspicuously absent from the grant of jurisdiction to the [Federal Home Loan Bank Board] is the enforcement of section 10(b)." 652 F. Supp. at 649. It further stated that "[t]he difference in the actions brought by the SEC and the FHLBB against [the thrift involved] underscores the court's conclusion that Congress did not intend to vest enforcement of the antifraud provisions of the securities laws with the FHLBB." Id.; see also Peoples Bank of Danville v. Williams, 449 F. Supp. 254, 260 (W.D. Va. 1978) (noting in dicta that "[t]he sole governmental agency charged with enforcing the

antifraud sections against banks is the SEC. Although federal banking officials hold concurrent jurisdiction to enforce some of the securities laws, they cannot enforce these antifraud sections").

In addition, bank customers, like other investors, have an implied private right of action under Exchange Act § 10(b) and Rule 10b-5.

D. SALES PRACTICE RULES	**D. SALES PRACTICE RULES**
• Broker-dealers and their associated persons must comply with Commission and SRO sales practice rules, particularly those relating to suitability and excessive prices.	**• Federal banking regulations do not include provisions for suitability requirements or other sales practice rules designed to protect investors who purchase securities through banks. Bank employees who sell securities are not subject to Commission and SRO sales practice rules.**

Federal banking statutes and regulations do not impose sales practice rules on bank employees engaged in securities activities. There is no counterpart under federal banking laws to the sales practice rules imposed on broker-dealers under federal securities laws.

It is noted that the federal banking agencies have adopted the following regulations (12 C.F.R. §§ 344.6 (FDIC), 208.8(k)(5) (Federal Reserve Board) and 12.6 (OCC)) requiring banks to establish written policies and procedures to address the assignment of responsibility for:
a. the supervision of employees and officers who transmit or execute customers' orders;
b. the fair and equitable allocation of securities and prices to accounts when similar orders for the same securities are received at the same time;

c. the crossing of buy and sell orders (where applicable and where permitted under local law), and

d. the disclosure of the securities activities of officers or employees of the bank who are involved in or obtain information with regard to investment recommendations or decisions for the accounts of customers. Notably, this disclosure need not include transactions involving in the aggregate $10,000 or less during the calendar year and transactions in mutual fund shares.

The regulations provide exemptions from the requirements of (a) through (c) where a bank averages less than 200 securities transactions per year for customers over the prior three year period. The OCC's regulation further provides that the Comptroller may waive one or more of the requirements of §12.6 in "appropriate cases." (12 C.F.R. § 12.7(d))

1. Suitability

● **Broker-dealers generally are required to "know their security" and "know their customer" when recommending securities products to customers.**

The NASD Rules of Fair Practice require broker-dealers to have reasonable grounds to believe that any security recommended to a customer is suitable for that customer, in view of the customer's financial situation and investment objectives. (NASD Rules of Fair Practice, art. III, § 2, NASD Manual (CCH) ¶ 2152; see also New York Stock Exchange Rule 405, "Diligence as to Accounts," NYSE Guide (CCH) ¶ 2405 (the "know your customer" rule))

1. Suitability

● **The federal banking statutes and regulations do not require banks to evaluate the suitability of investments recommended to customers.**

The Interagency Statement of the federal banking agencies requires bank employees involved in selling nondeposit investment products to adhere to "fair and reasonable sales practices" subject to compliance reviews by the bank's management. The guidelines state that bank employees recommending investments to customers should have reasonable grounds to believe that the product recommended is suitable for that customer on the basis of

The Commission and the SROs also have specific suitability requirements applicable to transactions in certain securities products that are considered particularly risky, e.g., options, limited partnerships, and "penny stocks." Thus, Commission Rule 15g-9 requires a dealer, before selling any penny stock, to obtain the customer's written authorization for the purchase, determine that the security is suitable for the customer, and provide the customer with a written statement setting forth the basis for such determination of suitability.

information disclosed by the customer. Bank employees should make "reasonable efforts" to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives and other relevant information. Notably, the guidelines omit half of the NASD suitability requirement that the broker know enough about the security to form a reasonable basis for a recommendation. Moreover, the guidelines never explicitly require that recommendations actually **be** suitable for customers. Also, because the guidelines are not mandatory, it is unclear what penalties would apply to bank employees that recommended unsuitable investments to bank customers or what remedies would be available to those customers.

Section 413 of the Comptroller's Handbook states that the NASD Rules of Fair Practice "do not expressly apply to sales or recommendations made directly by the bank...however, they are an appropriate reference for a bank compliance program designed to ensure that the bank's retail sales of all nondeposit investment products are operated in a safe and sound manner."

With regard to securities sales and recommendations, "the OCC now interprets the Interagency Statement provision on suitability to adopt standards identical to the NASD's suitability rule." (See OCC Letter to Robert L. Andersen, First Union Corporation (April 15, 1994); see also OCC Letter to Michael E. Bleier, General Counsel, Mellon Bank, N.A. (May 4, 1994))

2. Excessive prices: sales commissions and mark-ups

• Broker-dealers are subject to Commission and SRO rules prohibiting the charging of excessive prices and commissions.

The antifraud provisions of the federal securities laws (§ 10(b) of the Exchange Act and Rule 10b-5) proscribe deceptive pricing practices by broker-dealers. Charging retail customers excessive mark-ups without proper disclosure constitutes such a deceptive practice or scheme. The broker-dealer has an obligation to deal fairly with public customers. If a dealer's price to a customer includes an excessive mark-up over the prevailing market price, then, absent proper disclosure, the dealer has violated § 10(b) of the Exchange Act, and Rule 10b-5 thereunder.

The Commission has consistently held that undisclosed mark-ups of more than 10 percent above the prevailing market price violate federal securities laws. The NASD rules and policies prohibit excessive mark-ups whether or not disclosed.

The NASD requires its members to establish fair and reasonable markups and commissions. Dealer markups must reasonably relate to the current market price of the security. A 5% markup ordinarily would be considered a fair profit within the NASD Rules of Fair Practice. Commissions must also be reasonable. (NASD Rules, art. III, §§ 1, 4)

The NASD requires members participating in a public offering of securities to file with the NASD documents or information concerning the

2. Excessive prices: sales commissions and mark-ups

• Federal banking law prohibits as an unsafe and unsound practice excessive compensation or compensation that could result in a material financial loss to a bank. Federal banking statutes and regulations do not establish specific compensation requirements and procedures for bank employees, including employees effecting securities transactions for bank customers. Nor do they address mark-ups by bank employees for effecting securities transactions.

The antifraud provisions of the federal securities laws (Exchange Act § 10(b) and Rule 10b-5) proscribe deceptive pricing practices by banks as well as registered broker-dealers.

Federal banking law (12 U.S.C. § 1831p-1(a)) requires the federal banking regulators to prescribe by regulation certain safety and soundness standards for banks and bank holding companies. Such standards must prohibit as an unsafe and unsound practice excessive compensation or compensation that could result in a material financial loss to an institution. (12 U.S.C. § 1831p-1(c))

The federal banking regulators have not defined how institutions are to set compensation under the safety and soundness standards prescribed under § 1831p-1(c). Rather, the institutions are required to select a method designed to prevent payment of compensation, fees, or benefits that are not excessive or could lead to material financial loss, based on specific considerations set forth in a proposed FDIC

underwriting terms and arrangements. NASD rules prohibit members from participating in public offerings of securities where the underwriting terms and arrangements are deemed by the NASD to be "unfair or unreasonable." (NASD Rules, art. III, § 44 (Corporate Finance Rule)) In addition, NASD rules require that a member affiliated with the issuer use an unaffiliated NASD member to price an offering of that issuer's securities. (Schedule E to the By-Laws) Following a favorable review of the underwriting terms and arrangements, the NASD provides an opinion that it has no objection to the members' participation in the proposed underwriting.

Article III, § 26(d) of the NASD Rules of Fair Practice establish maximum fees charged by broker-dealers engaged in open-end mutual funds' sales. Under the Rule, member broker-dealers are prohibited from offering or selling shares of any open-end investment company registered under the Investment Company Act of 1940 if the sales charges described in the prospectus are excessive. The Rule sets forth detailed guidelines with respect to excessive aggregate sales charges.

Under the general antifraud provisions (§ 10(b) of the Exchange Act and Rule 10b-5), every sale by a broker-dealer carries with it an implied representation that the price is reasonably related to that prevailing in the open market. In addition, a number of Commission rules pertain expressly to pricing. These include:

rule. (See 58 FR 60802, 60805, 60819-20)

The Interagency Statement of the federal banking agencies also does not establish specific compensation requirements and procedures, but instead charges each bank with developing its own program. The guidelines state that the bank's policies and procedures should include a "description" of the compensation arrangements for employees authorized to sell investment products and those personnel having contact with customers concerning the bank's sales program. The guidelines make no reference to mark-ups by bank employees.

The guidelines authorize bank employees, including tellers, to earn a one-time nominal fee of a fixed dollar amount for each customer referral for nondeposit investment products. Banks should not pay employees participating in the referral programs compensation based on the success of a sale. The compensation programs should not operate as an incentive for salespeople to sell retail nondeposit investment products over a more suitable option.

Section 413 of the Comptroller's Handbook directs examiners to assess the steps bank management has taken to ensure that compensation programs do not operate as an incentive for salespersons to make unsuitable recommendations or sales to customers. The section notes that one way to avoid having the compensation system drive the recommendation toward mutual funds and away from certificate of deposit ("CD") renewals would be to either separate the nondeposit investment product

Commission Rule 15c1-8 prohibits a broker-dealer from representing a "market price" unless it has reasonable grounds to believe a trading market in fact exists in the security.

Commission Rule 15c2-7 implements the prohibition contained in §15(c)(2) of the Exchange Act against a broker-dealer's use of fictitious quotations (e.g., bids or offers based on an undisclosed arrangement between correspondent broker-dealers).

Commission Rule 15c2-11 prohibits broker-dealers from publishing quotations without first obtaining, reviewing, and keeping records of specified information regarding the security.

E. DUTY TO SUPERVISE

• **Broker-dealers are subject to sanctions for failure to adequately supervise their employees. Broker-dealers are also subject to controlling person liability for employees who engage in violations of the federal securities laws.**

Section 15(b)(4)(E) of the Exchange Act imposes a duty to supervise on registered broker-dealers. The Commission has significant enforcement remedies available if brokerage firms fail to supervise their employees adequately to prevent violations of the securities laws.

The NASD Rules of Fair Practice (§27) also require members to maintain written procedures to ensure their employees' compliance with securities laws, regulations, and NASD policies.

New York Stock Exchange Rule 342(a) imposes a general obligation on a "person in charge

sales and CD renewal functions or to compensate employees for both renewals of maturing deposits as well as the selling of nondepoist investment products.

E. DUTY TO SUPERVISE

• **There is no particular provision in federal banking law imposing sanctions on banks for failure to adequately supervise their employees engaged in securities activities.**

Federal banking regulations do, however, require banks to establish written policies and procedures to address the assignment of responsibility for the supervision of employees and officers who transmit or execute customers' orders. See 12 C.F.R. §§ 12.6 (OCC), 208.8(k)(5) (Federal Reserve Board), 344.6 (FDIC).

The Interagency Statement of the federal banking agencies does not establish a uniform standard of supervision of bank employees involved in sales of nondeposit investment products to bank customers. The guidelines only state that bank's senior management should designate individuals to supervise each

of a group of employees [to] reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees." In proceedings brought under the rule, the courts have applied decisions in which the Commission has held that the president of a broker-dealer is "in charge" of all the firm's employees and activities and is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in the firm. (See, e.g., Patrick v. SEC, No. 93-4148 (2d Cir.) (January 18, 1994))

In addition to SRO regulation, broker-dealer firms establish rules and procedures for their representatives at the firm level, and provide an initial level of review through their duty to supervise their employees. Generally, at least one office in the broker-dealer firm, managed by a registered principal, is responsible for reviewing the firm's compliance activities.

Section 20(a) of the Exchange Act establishes liability for broker-dealers for the conduct of any controlled persons liable under any provision of the Exchange Act or any rule or regulation thereunder, subject to a good faith defense.

1. Chinese Walls

• **Broker-dealers must establish internal policies and procedures to restrict the flow and prevent the misuse of material nonpublic information.**

Section 15(f) of the Exchange Act requires registered broker-

activity outlined in the bank's policies and procedures adopted under the guidelines; that bank personnel with supervisory responsibilities should receive training "appropriate to that position."

1. Chinese Walls

• **Banks are required under the federal banking laws to establish and maintain policies and procedures providing for the disclosure of the securities activity of bank personnel who are involved in investment recommendations; however, the**

dealers to maintain and enforce written policies and procedures reasonably designed to prevent the misuse, in violation of the statute or the rules and regulations thereunder, of material, nonpublic information by the broker-dealers or their associated persons.

A notable area of oversight by SROs concerns the policies and procedures employed by broker-dealers to segment the flow of sensitive information, often referred to collectively as "Chinese Walls." For example, Commission Rule 14e-3 prohibits the trading of securities which may be the subject of a tender offer while in possession of material nonpublic information. However, paragraph (b) of the rule provides a safe harbor for transactions by multi-service financial institutions under certain circumstances that otherwise would be proscribed, provided, among other factors, that the broker-dealer firm has established reasonable policies and procedures to ensure that the individuals making the investment decisions for the firm were not trading on the basis of material nonpublic information obtained from another area of the firm.

federal banking laws do not comprehensively address conflict of interest issues.

The federal banking agencies require banks to establish written policies and procedures to address the assignment of responsibility for the disclosure of the securities activities of officers or employees of the bank who are involved in or obtain information with regard to investment recommendations or decisions for the accounts of customers. (This disclosure need not include transactions involving in the aggregate $10,000 or less during the calendar year and transactions in mutual fund shares.) (12 C.F.R. §§ 12.6 (OCC), 208.8(k) (Federal Reserve Board), 344.6 (FDIC))

The Interagency Statement of the federal banking agencies does not prescribe or suggest appropriate limitations on the use of bank customer information. The guidelines simply require banks to adopt procedures addressing "the use" of such information for any purpose in connection with bank-related retail investment sales activities. Moreover, the guidelines do not comprehensively address conflict of interest issues, such as limitations on a bank's communication of nonpublic customer information to an affiliated investment company.

Section 413 of the <u>Comptroller's Handbook</u> advises examiners that if banks use customer lists to telephone depositors whose certificates of deposit are due to mature for the purpose of informing them about alternative investment products, the banks should have policies outlining steps to avoid customer confusion as to the risks associated with nondeposit investment products,

including their uninsured nature. The section also authorizes banks to supply customer information lists to a third party vendor, after bank management has evaluated the steps being taken by the third party to avoid customer confusion and has determined that such steps are consistent with the bank's. It is suggested that bank management obtain a legal opinion concerning its authority to share customer information with third parties. (See OCC Bulletin 94-13 at 4)

The Federal Reserve Board expects each State member bank exercising investment discretion for the accounts of others to adopt written policies and procedures to ensure that material inside information in its possession is not misused.

F. DISCIPLINARY PROCEEDINGS

• Broker-dealers are subject to disciplinary sanctions ranging from censure to revocation of their registration if they engage in activities that violate the federal securities laws, the rules adopted thereunder, or SRO rules. Public releases describe the nature of the proceedings and the identity of parties disciplined.

Both the Commission and the SROs may bring disciplinary proceedings against registered broker-dealers and their associated persons for violations of securities laws and Commission rules.

The Commission may bring civil injunctive actions or administrative proceedings against individuals and firms for violations of the U.S. securities laws and Commission rules. In administrative proceedings, the

F. DISCIPLINARY PROCEEDINGS

• Banks and bank-related parties are subject to disciplinary sanctions ranging from censure to removal if they engage in unsafe and unsound practices or violations of laws, regulations or supervisory agreements. Public releases of the proceedings do not describe the nature of the proceedings.

As noted above, the federal banking regulators have authority under 12 U.S.C. §1818 to bring administrative proceedings against banks and bank-related parties for unsafe and unsound practices that pose a financial threat to a bank, or for violations of laws, regulations, or supervisory agreements. In such proceedings, the banking regulators may (among other things) impose temporary and permanent cease and desist orders, and/or require an "institution-affiliated party"

Commission may (among other things) censure; suspend or bar -- for life, or for life but with permission to reapply to the Commission after passage of a specified period of years -- firms and individuals from acting as broker-dealers or associated persons of broker-dealers; limit the functions and operations of a broker-dealer; or revoke a broker-dealer's registration. (Exchange Act §§ 15(b)(4), (6)) The Commission may also impose cease and desist orders and/or civil money penalties. (Exchange Act §§ 21B, 21C)

Each SRO has rules specifying procedures for disciplining members who violate the securities statutes or Commission rules. (Exchange Act §§ 6(b)(6), 15A(b)(8), and 15A(h)) SRO rules also set forth disciplinary procedures and penalties for violations of the SRO's own rules. (See, e.g., NASD Rules of Fair Practice, art. V, § 1, providing for monetary fines, suspension from membership or associated person status, and expulsion or revocation of associated person registration.) SRO action taken in connection with such disciplinary proceedings may be appealed to the Commission (or the Commission may review the SRO action on its own motion). (Exchange Act §§ 19(d), (e), (f))

Commission and SRO disciplinary proceedings are matters of public record. Public releases describe the nature of the proceedings and the identity of parties disciplined.

In addition (as mandated by Exchange Act § 15A(i)), the NASD operates an "800" number hotline which allows investors to obtain information about the (including a bank officer or director) to be removed from the bank or barred from the banking industry. (12 U.S.C. §§ 1818(b), (c), (e), (g)) In addition, the federal banking agencies may apply to federal district court for enforcement of any administrative order issued under 12 U.S.C. § 1818, and may obtain civil money penalties for violations of any such order. (12 U.S.C. § 1818(i))

The Interagency Statement of the federal banking agencies provides that failure of a bank to establish and observe appropriate policies and procedures in connection with sales activities involving nondeposit investment products will be subject to "criticism and appropriate corrective action." Notably, the guidelines contained in the statement are not regulations and, therefore, are not enforceable by the banking agencies under 12 U.S.C. § 1818.

The federal banking agencies are required to "publish and make available to the public" any final order issued in connection with any administrative enforcement proceeding. (12 U.S.C. §1818(u)) Releases issued by the federal banking agencies, however, usually do not describe the nature of the violation and the enforcement action taken. Rather, the releases are lists of enforcement actions that typically only include the docket number, names of the parties involved, the type of action, the date of the action, and whether the action was by consent. It is difficult for an investor to determine from the listings which proceedings are of interest in order to request copies of documents of specific final

disciplinary and civil liability records of broker-dealers' registered representatives. Moreover, registration data on associated persons (including employment history, education, and disciplinary history) is available to the Commission, SROs and all state securities regulators through a computer accessible Central Registration Depository administered by the NASD.

actions from the banking agencies.

1. Investor Actions

● **The federal securities laws have been interpreted to confer private rights of action to investors for certain violations of the federal securities laws, including the major antifraud provisions. In addition, SRO rules require broker-dealers to resolve disputes with their customers in industry-sponsored arbitration forums that are subject to Commission oversight.**

Individuals and private entities may bring private rights of action in federal court seeking redress for violations of certain provisions of the securities laws and SRO rules. For example, investors have an implied right of action under Rule 10b-5 and § 10(b) of the Exchange Act. Individuals also may bring actions arising under the securities laws in the SRO arbitration forums. In addition, section 29(b) of the Exchange Act provides that contracts made in violation of the Exchange Act or rules under the Exchange Act are voidable by the aggrieved party. This provides investors with a private right of action for rescission.

The SROs operate arbitration programs for resolution of disputes between SRO members and

1. Investor Actions

● **Federal banking laws do not generally contain private rights of action for investors and there is no banking law counterpart to the securities arbitration scheme for bank securities investors.**

Bank securities customers, like other investors, have an implied right of action under Rule 10b-5 and § 10(b) of the Exchange Act.

Bank securities customers, however, have no formal avenue of redress for complaints under federal banking laws. The federal banking laws do not generally contain private rights of action for investors (See, e.g., In re Fidelity Bank Trust Fee Litigation, 839 F. Supp. 318 (E.D. Pa. 1993); In re Corestates Trust Fee Litigation, 837 F. Supp. 104 (E.D. Pa. 1993)), and there is no banking law counterpart to the securities arbitration scheme.

between an SRO member and its customers. Generally, the arbitration program is overseen by a committee of the SRO and administered by SRO staff under detailed uniform rules adopted by the SROs and using model rules developed by the Security Industry Conference on Arbitration ("SICA"). (See NASD Code of Arbitration Procedure)

G. FINANCIAL RESPONSIBILITY

● Broker-dealers are required to meet net capital and other operational and financial competence standards established by the Commission to protect the customers and creditors of broker-dealers.

Section 15(b)(7) of the Exchange Act requires broker-dealers to meet such operational and financial competence standards as the Commission may establish.

Pursuant to § 15(c)(3) of the Exchange Act, the Commission has promulgated rules establishing minimum financial responsibility standards for broker-dealers engaged in securities activities.

The Commission's net capital and customer protection rules are designed to protect the customers and creditors of a broker-dealer and to ensure that sufficient liquid assets are available regardless of the activities of the broker-dealer holding company and affiliates.

1. Net Capital Rule

● Broker-dealers must meet certain basic financial responsibility standards to assure that customers can recover their funds and securities in the event the broker-dealers become insolvent.

G. FINANCIAL RESPONSIBILITY

● Bank regulatory agencies require that banks and bank holding companies maintain certain levels of capital. These capital rules, however, are not specifically designed with securities activities in mind.

1. Net Capital Rule

● Banks are not required under the federal banking laws to satisfy specific capital requirements in order to engage in securities activities. Bank securities operations are not subject to the net capital

Commission Rule 15c3-1 prescribes minimum liquidity standards for broker-dealers. The rule requires broker-dealers to maintain sufficient liquid assets to meet the claims of their customers and other broker-dealers in the event the broker-dealer fails, as well as a cushion of liquid assets in excess of liabilities to protect against potential market and credit risks. The rule describes how the broker-dealer should compute "net capital."

Net capital is defined as a broker-dealer's net worth computed in accordance with generally accepted accounting principles, plus subordinated liabilities, less assets not readily convertible into cash and most unsecured receivables. The broker-dealer then subtracts prescribed percentages (or haircuts) from the market value of securities and commodities owned by the broker-dealer. The rule requires broker-dealers to mark their securities and commodities positions to market value.

The Commission's monitoring of compliance with the financial responsibility rules is aided by the filing by broker-dealers of financial and operations reports ("FOCUS Reports") on a periodic basis.

In addition to the Commission's financial responsibility standards, all the SROs require a statement of financial condition as part of their membership application.

Commission Rule 17a-5 requires broker-dealers to file monthly and quarterly FOCUS reports as well as annual, independently audited financial reports with **requirements developed for the protection of broker-dealer customers.**

12 U.S.C. § 3907 requires federal banking regulators to establish minimum levels of capital for banks and bank holding companies. (See, e.g., 12 C.F.R. § 3 (OCC)) Under the Uniform Interagency Bank Rating System, capital adequacy is only one of five elements used by the federal banking regulators to evaluate the financial condition of banks and bank holding companies for supervisory purposes. The other elements are: asset quality, management ability, earnings performance, and liquidity. The elements are summarized by the acronym "CAMEL."

Notably, the purpose of the capital adequacy standards imposed by federal banking regulators on banks is to protect depositors and the financial system. Capital adequacy does not require banks to maintain specific liquidity standards to assure that customers can recover their funds and securities in the event the bank becomes insolvent. However, securities owned by a bank customer that are held for safekeeping by a bank do not become property of the receivership estate and are returned to the customer if the bank fails.

Federal banking law requires the federal banking agencies to establish a capital-based supervisory system requiring prompt correction of problem institutions based on their capital status, e.g., well capitalized or critically undercapitalized. (12 U.S.C. § 1831o) As a general rule, only adequately capitalized banks and bank holding companies are

the Commission. The rule also requires broker-dealers to file a report with the Commission upon termination of their membership interest in an SRO. Moreover, broker-dealers that carry customer accounts are required to send their customers an audited balance sheet and other information.

Commission Rule 17a-11 requires a broker-dealer to notify the Commission and its designated examining authority ("DEA") when its net capital is less than 120% of its required minimum amount (early warning level) and its net capital falls below the minimum amount required by the net capital rule. In addition, Rule 17a-11 requires a broker-dealer to notify the Commission and its DEA when the broker-dealer's books and records are not being kept current. In addition, under Commission Rule 15c3-1(e), broker-dealers must provide the Commission with a two business day advance notice of withdrawal of equity capital in excess of 30 percent of the broker-dealer's excess net capital in any 30-day period, and may not withdraw the capital in the event that it would reduce the broker-dealer's net capital to less than 120 percent of its required minimum amount.

The NASD Rules of Fair Practice (Art. III § 22) require broker-dealers to send their customers certain annual financial statements dealing with, among other points, the firm's subordinated loans, its required and actual net capital, and material deficiencies (if any). Every six months, the firm must send its customers an uncertified balance sheet and statement of the firm's net and required net capital.

permitted to expand their activities, unless the institutions have implemented a capital restoration plan approved by the appropriate federal banking regulator.

The federal banking regulators have issued regulations discussing the capital categories assigned to national banks for purposes of procedures pertaining to prompt corrective actions ("PCA") under the § 1831o. In considering appropriate PCAs, the federal banking agencies may consider securities violations, including those affecting capital levels. The federal banking agencies also have noted that they retain the right to institute PCA proceedings pursuant to their regulatory authority in cases where a violation of the federal securities laws adversely affects a national bank's capital level. (PPM-5310-5 (Rev.) July 7, 1993)

Section 413 of the Comptroller's Handbook advises national bank examiners that the OCC may view banks operating a retail securities business without appropriate suitability procedures to be engaging in an unsafe and unsound practice because litigation by dissatisfied customers could introduce risk to the banks' capital.

2. Customer Protection Rule

● **Broker-dealers are required to maintain sufficient funds to assure that their customers can recover those funds in the event the broker-dealers become insolvent.**

Commission Rule 15c3-3, first, requires a broker-dealer to promptly obtain and maintain physical possession or control of all fully paid and excess margin customer securities. On a daily basis, a broker-dealer is required to make a determination that it is in compliance with this rule.

Second, Rule 15c3-3 precludes a broker-dealer from using customer funds and securities to finance firm overhead and dealer activities. Under this aspect of the rule, a broker-dealer is required to make a periodic computation to determine the amount of customer-related money that must be segregated in a Special Reserve Bank Account for the Exclusive Benefit of Customers.

Commission Rule 17a-13 requires most broker-dealers to conduct a quarterly count of all customer and firm securities.

Under the NASD's Rules of Fair Practice (Art. III §19) members are forbidden to make improper use of a customer's securities or funds. This prohibition applies to improper holding of fully paid securities in cash accounts or excess collateral securities in margin accounts.

2. Customer Protection Rule

● **Banks are not required to maintain sufficient funds to assure that their securities customers can recover those funds in the event the banks become insolvent.**

National banks, however, are required to segregate all assets held in any fiduciary capacity from the general assets of the bank, except with regard to a common trust fund maintained exclusively for collective investment. (12 U.S.C. § 92(c); 12 C.F.R. §§ 9.13 and 9.18) National banks, therefore, are required to segregate customer funds to the extent that the banks engage in brokerage activities in their trust departments.

Securities owned by a bank customer that are held in safekeeping by a bank, moreover, do not become property of the receivership estate and are returned to the customer if the bank fails. Cash from securities transactions held in deposit accounts is covered by FDIC insurance, up to $100,000.

3. Risk Assessment

● **Broker-dealers are subject to risk assessment recordkeeping and reporting requirements with**

3. Risk Assessment

● **Bank holding companies are subject to detailed recordkeeping and reporting requirements but**

respect to activities engaged in by their affiliates.

Under the Market Reform Act of 1990 ("Reform Act"), the Commission is authorized to monitor the activities of broker-dealer affiliates and holding companies. The Reform Act also empowers the Commission to obtain more detailed reports during periods of market stress or when information contained in the quarterly reports or other information leads the Commission to conclude that supplemental information is necessary to assess the financial or operational condition of a particular broker-dealer.

Pursuant to the Reform Act, the Commission adopted Rules 17h-1T and 17h-2T, which establish a risk assessment recordkeeping and reporting system for broker-dealers.

Under Rules 17h-1T and 17h-2T, certain broker-dealers are required to identify any affiliated entities whose business activities are reasonably likely to have a material impact on the financial and operational condition of the broker-dealer. For the purposes of the risk assessment rules, these affiliates are known as "Material Associated Persons." Broker-dealers are required to maintain information concerning the financial and securities activities of each Material Associated Person and to file summaries of that information in quarterly reports with the Commission on Form 17-H.

4. Limitations on Extensions of Credit

such requirements are not focused on securities activities engaged in by affiliates.

Under federal banking law, the Federal Reserve Board prescribes that bank holding companies establish and maintain systems for monitoring and controlling financial and operational risks to them resulting from affiliate activities that are likely to materially impact their capital, liquidity or ability to conduct or finance their operations. (12 U.S.C. § 1841 et seq.) While such risk assessment recordkeeping and reporting requirements are broader than those imposed under federal securities laws, they are not focused on affiliates' securities activities.

4. Limitations on Extensions of Credit

- **The extension of credit by broker-dealers to their customers is limited.**

Section 7 of the Exchange Act authorizes the Federal Reserve Board to limit the amount of credit that may be extended by broker-dealers for the purchasing or carrying of non-exempted securities. Under this authority, the Board has promulgated rules, or margin requirements, governing the extension of credit by registered broker-dealers (Regulation T, 12 C.F.R. § 220.1-220.130) and by banks (Regulation U, 12 C.F.R. § 221.1-221.124).

Under § 7 of the Exchange Act, the Federal Reserve Board's margin requirements must base the initial extension of credit on an amount not greater than the higher of (1) 55 percent of the current market price of the security, or (2) 100 percent of the lowest market price of the security during the preceding 36 calendar months, but no more than 75 percent of the current market price.

Regulation T's principal purpose is to regulate extensions of credit by and to broker-dealers. It imposes, among other obligations, initial margin requirements and payment rules on securities transactions. It provides a margin account and seven special purpose accounts in which to record all financial relations between a customer and a creditor. Any transaction not specifically permitted in a special account must be recorded in a margin account. Regulation T does not preclude any exchange, national securities association, or creditor from imposing additional requirements or taking action for its own protection.

- **Limitations on extension of credit by banks to their securities customers are less restrictive than limitations imposed on broker-dealers.**

Section 7(d) of the Exchange Act grants the Federal Reserve Board authority to regulate <u>any</u> bank loan for the purpose of purchasing or carrying <u>any</u> security (except for a loan "on a security other than an equity security"). However, Regulation U, as promulgated by the Federal Reserve Board, is more limited in scope and applies only to extensions of credit by banks on "margin stock" for the purpose of purchasing or carrying "margin stock."

Under Regulation U, banks can loan money for a broader range of securities purchases and are accorded more flexible collateral requirements than broker-dealers are under Regulation T.

Regulation U does not apply to purchases of non-margin stock; nor does it apply when collateral used is other than stock even if the purpose of the loan is to purchase margin stock. In addition, banks can make unsecured loans for the purpose of purchasing securities.

The Commission in practice leaves the policing of Regulation U to the federal and state bank examining authorities under an arrangement whereby substantial violations are to be brought to the Commission's attention. But even with respect to banks, any injunctive proceeding must be brought in the Commission's name under § 21(e) of the Exchange Act. Under section 21, the Commission may seek civil money penalties in addition to federal district court injunctive

Broker-dealers are regulated more stringently under Regulation T than banks are regulated under Regulation U. Regulation T essentially limits the kinds of securities eligible for lending by broker-dealers to margin securities (i.e., listed equities and certain approved OTC stocks).

Moreover, the exchanges and the NASD impose margin maintenance requirements on broker-dealers that are more stringent than the Federal Reserve Board's Regulation T requirements. Under these margin maintenance rules, the current market value of the collateral must be at least 25 percent of the account's total value. Thus, there are minimum margin maintenance requirements for all accounts. (New York Stock Exchange Rule 431(c)(2); American Stock Exchange Rule 462(c)(2)(A); NASD Rules of Fair Practice Art. III, sec. 30, App. A, sec. 4(a)(n)).

While the power to regulate extensions of credit under § 7 is vested in the Federal Reserve Board, enforcement of the rules with respect to broker-dealers is the responsibility of the Commission and the SROs. A substantial number of proceedings have been brought against broker-dealers for violations of the margin rules, which bar them not only from extending credit in violation of the Federal Reserve Board's limitations but also from arranging for the extension of such credit by others (Exchange Act § 7(c); 12 C.F.R. § 220.7(a)).

Under § 11(d)(i) of the Exchange Act, broker-dealers may not extend, maintain or arrange for the maintenance or extension of credit to or for customers on the purchase of a security that is actions. Moreover, civil penalties and aiding and abetting liability may be assessed by the Commission against any bank if the customer or its broker-dealer is found in violation of Regulation T, and if the bank has knowledge of the facts and assists the scheme, e.g., by extending credit to finance free-riding.

part of a new issue if they have participated in a primary distribution of that issue within the past 30 days.

H. RECORDKEEPING AND CONFIRMATIONS

• Broker-dealers are subject to comprehensive recordkeeping and reporting requirements for securities transactions.

1. Recordkeeping

Section 17 of the Exchange Act specifies certain basic recordkeeping and reporting requirements for broker-dealers. The recordkeeping and reporting requirements are incorporated in a series of Commission rules under § 17 of the Exchange Act. The rules were promulgated, among other reasons, to provide the Commission with early warning of danger signs so as to telegraph notice of violations of the net capital rule or appropriate standards of broker-dealer conduct. The books and records of broker-dealers must be made available for Commission or SRO inspection without notice at any reasonable time.

Commission Rule 17a-3 requires registered broker-dealers to make and keep current records detailing, among other things, securities transactions, money

H. RECORDKEEPING AND CONFIRMATIONS

• Federal banking regulators have adopted only limited recordkeeping and confirmation requirements for securities transactions.

The federal bank regulators have adopted regulations detailing records required to be established and maintained and notification furnished to customers in connection with securities transactions effected by banks for their customers. (12 C.F.R. §§ 12.1-7 (OCC); 208.8(k) (Federal Reserve Board); 344.1-.7 (FDIC)).

1. Recordkeeping

Banks are required to maintain, for at least three years, the following records: chronological records of original entry which include purchase and sale information; account records for each customer reflecting all stock and cash activity; each order ticket whether executed or not; and a record of all broker-dealers used to execute transactions and the amount of commission paid during the year. All except for the first are not required for banks having an average of less than 200 securities transactions per calendar year.

balances, and securities positions.

Commission Rule 17a-4 specifies record retention and preservation requirements for registered broker-dealers.

Commission Rule 17a-8 requires broker-dealers subject to the Currency and Foreign Transactions Reporting Act of 1990 to comply with the reporting, recordkeeping and record retention requirements of the Act as well as those of the Exchange Act.

The NASD Rules of Fair Practice (Art. III §21) require each member to keep and preserve any records applying to account information, in addition to a complaint file.

2. Confirmations

● **Broker-dealers are required to provide customers with written, detailed information on securities transactions effected for their customers.**

Commission Rule 10b-10 requires broker-dealers, at or before completion of a transaction, to give or send to the customer a written document that details information on specific trades. In general, the rule requires disclosure of the date, time, identity, price and number of shares involved in the transaction. With respect to debt securities, the rule requires disclosure of information on price, yield and call provisions. Notably, the rule requires disclosure of the broker-dealer's compensation. When the broker-dealer acts as agent, it must disclose its commission; when it acts as principal, it generally must disclose the mark-up or mark-down

2. Confirmations

● **Regulations of the federal banking agencies require banks to provide customers with limited written information on securities transactions effected for their customers.**

The federal banking confirmation regulations require written notification to be mailed or furnished within five business days from the transaction date, or, if a broker-dealer is used, within five business days from the bank's receipt of the broker's confirmation, unless otherwise excepted.

Banks effecting transactions for customers are required to maintain for at least three years and furnish to the customer either of the following two forms of notification:
(1) A copy of the broker-dealer confirmation and a statement of the source and amount of remuneration, if any, to be

it received. This information is designed to allow the customer to verify that the broker-dealer did the trade requested, to compare the execution price of the trades, and disclose material conflicts of interest between the customer and the broker-dealer.

In March 1994, the Commission proposed amendments to Rule 10b-10 to strengthen the rule's investor protection function. (59 Fed. Reg. 12,767 (March 17, 1994)) The proposed amendments would: (1) require confirmation disclosure of mark-ups and mark-downs for riskless principal transactions in debt securities; (2) require disclosure of the fact that a debt security is not rated by a nationally recognized statistical rating organization; (3) require confirmation disclosure of mark-ups and mark-downs in Nasdaq and exchange-listed securities; (4) require disclosure regarding whether broker-dealers are not members of the Securities Investor Protection Corporation ("SIPC"); (5) modify the disclosure requirements with respect to certain collateralized debt securities; (6) add a preliminary note to the Rule indicating that the Rule's disclosure requirements do not limit disclosures necessary under the antifraud provisions of the federal securities laws; and (7) restructure the Rule.

received by the bank (the remuneration statement is required only if such remuneration is not determined pursuant to a prior written agreement between the bank and the customer), or (2) A notification that discloses the bank's and the customer's name; the capacity in which the bank is acting; the date and time of execution; the identity, price and number of shares or units; the amount of remuneration received or to be received by a broker-dealer from the customer in connection with the transaction and by the bank, unless remuneration is determined pursuant to a written agreement between the bank and the customer. Also disclosed is the name of the broker-dealer used, or, if none, the name of the person from whom the security was purchased or to whom it was sold or the fact that such information will be furnished upon request.

Under the OCC's regulations (12 C.F.R. § 12.7(d)), the Comptroller may waive one or more of the recordkeeping and confirmation requirements "in appropriate cases."

In addition to the confirmation disclosures that are required under their regulations, the federal banking agencies' Interagency Statement states that in the event the confirmations or account statements contain the name or the logo of the bank or an affiliate, employees must make certain minimum disclosures clarifying that the products are not FDIC-insured.

3. <u>Lost and Stolen Securities</u>

- **Broker-dealers must report lost or stolen securities to the Commission or its designee and,**

3. <u>Lost and Stolen Securities</u>

- **Banks must report lost or stolen securities to the**

in some cases, to the Federal Bureau of Investigation ("FBI").

Section 17(f)(1) of the Exchange Act grants to the Commission broad rulemaking authority to establish procedures for reporting and inquiring about missing, lost, stolen and counterfeit securities. Pursuant to this authority, the Commission adopted Rule 17f-1 which governs the Commission's Lost and Stolen Securities Program ("Program").

Commission Rule 17f-1 requires all broker-dealers (regardless of whether they are registered with the Commission as broker-dealers), members of the Federal Reserve System, and banks whose deposits are insured by the FDIC, to register with and report to the Commission or its designee, the Securities Information Center ("SIC"), regarding missing, lost, counterfeit or stolen securities, unless otherwise excepted. Reports to the Commission or the SIC are filed on Form X-17F-1A.

When a securities certificate comes into the possession of a Program participant, it must make an inquiry to the SIC to determine whether the securities certificate previously was reported lost, missing, counterfeit or stolen. When an inquiry into the system matches a missing, lost, counterfeit or stolen security report (commonly referred to as a "hit"), the SIC provides the inquiring broker-dealer or bank with the name, address and telephone number of the institution that reported the loss. The institution that reported the loss also is notified, as is the FBI if there are any indications that potential criminal activity may be involved.

Commission's designee, the SIC, and to the FBI.

Banks are required to report all lost and missing securities pursuant to the Commission's reporting requirements set forth in 17 C.F.R. § 240.17f-1.

Commission Rule 17f-1 governs the Lost and Stolen Securities Program which requires banks receiving or holding securities to file a registration form, maintain records, and make certain inquiries and reports in connection with securities coming into their possession or control. Registration filings, inquiries and reports are made through the SIC.

Each registered institution must report to the SIC, and the appropriate transfer agent, those securities which it discovers to be missing, lost or stolen, or counterfeit. Counterfeit and stolen securities also must be reported to the FBI. There is a timetable for reporting the missing, lost, stolen or counterfeit securities.

The Commission permits banks to file with the FBI the Criminal Referral Form required by the federal banking regulators, instead of Form X-17F-1A. However, the Criminal Referral Form must be filed within the time frames specified in Commission Rule 17f-1. Banks must file Form x-17F-1A with the SIC because the Criminal Referral Form does not request all the information required by Rule 17f-1(c)(5).

National banks need not file Criminal Referral Forms under 12 C.F.R. § 21.11 for lost, missing, counterfeit or stolen securities if a report is filed pursuant to

the reporting requirements of 17 C.F.R. § 240.17f-1.

J. INSOLVENCY PROTECTION

• **Broker-dealers must contribute to an industry-wide fund to protect their securities customers in the event the broker-dealers become insolvent.**

The Securities Investor Protection Act of 1970 ("SIPA") (§ 3(a)) created SIPC, a non-profit membership corporation, for the purpose of protecting customers of the broker-dealers by ensuring that they receive back their cash and securities in the event of a broker-dealer liquidation.

All registered broker-dealers must be members of SIPC unless their principal business is conducted outside of the U.S. or their broker-dealer business consists exclusively of the distribution of investment company shares, the sale of variable annuities, the business of insurance, or the business of rendering investment advice to registered investment companies or insurance company separate accounts. (SIPA §§ 3(a)(2))

SIPC protects each customer of a failed SIPC member broker-dealer up to $500,000 for claims for cash and securities, except that claims for cash are limited to $100,000 per customer (SIPA § 6(a), (f))

SIPC is funded by assessments on its members and the interest earned on fund assets. It has statutory authority to borrow up to $1 billion from the U.S. Treasury Department, through the Commission. (SIPA §§ 4(c), (d) and (g))

J. INSOLVENCY PROTECTION

• **Bank brokerage customers are not protected by SIPC insurance. In the event of a bank failure, however, bank brokerage customers are protected by FDIC insurance with respect to cash arising from securities transactions that is held in deposit accounts (up to $100,000). Securities held in safekeeping are returned to the owners.**

When an insured bank fails, the FDIC usually becomes the receiver (12 U.S.C. § 1821(c)). When the FDIC is appointed receiver, it has the choice of engaging in a deposit payoff (12 U.S.C. § 1821(f)) or engaging in a purchase and assumption transaction (12 U.S.C. § 1823(c)). Regardless of which avenue the FDIC uses to fulfill its receivership responsibility, its function is to provide payment to bank **depositors** of up to $100,000 each. (12 U.S.C. § 1821(a)) FDIC insurance does not protect customers' securities held at banks; nor are such accounts protected by SIPC insurance. However, securities owned by bank customers held by the bank for safekeeping are not considered to be part of the receivership estate and are returned to the customers.

The Interagency Statement represents a recognition by the federal banking agencies that banks recommending or selling nondeposit investment products, such as mutual funds and annuities, need to ensure that customers understand the differences between nondeposit products and insured deposits. Toward this end, the guidelines

SIPC is subject to oversight by the Commission. For example, the Commission may require SIPC to adopt, amend, or repeal any bylaw or rule.

If SIPC determines that a member broker-dealer has failed or is in danger of failing to meet its obligations to customers, the SIPC may apply for a court order, trustee and receivership.

The trustee's responsibilities are to return customer property, complete the firm's contract commitments, and liquidate the business. In limited situations involving smaller firms, SIPC protects the customers by paying them directly. Normally, the trustee and SIPC will try to have some or all customer accounts transferred from the failed broker-dealer to another SIPC member broker-dealer. If transfer is not effected, the trustee satisfies claims on an individual basis after the customer files his claim with the trustee.

The Commission has the ability and has shown the willingness to intervene long before a broker-dealer is insolvent. Falling net capital levels trigger measures designed to facilitate the Commission's oversight and to prevent further deterioration of capital.

state that banks should ensure that their employees clearly and fully disclose to retail customers that the investment products are not insured by the FDIC; are not deposits or other obligations of the bank and are not guaranteed by the bank; and are subject to investment risks, including possible loss of the principal invested. Moreover, the guidelines state that any representation concerning insurance coverage should not suggest or imply that any alternative insurance coverage is the same as or similar to FDIC insurance.

The guidelines advise banks to obtain a statement, signed by the customer, acknowledging that the customer has received and understands the disclosures. The guidelines also state that information concerning investment products should be clearly separate from the information concerning the deposit account on a customer's periodic deposit account statement and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction.

K. EXAMINATIONS

• **Broker-dealers are examined by the Commission and their DEA to assure compliance with the federal securities laws, Commission and SRO rules.**

Section 17(b) of the Exchange Act authorizes the Commission to conduct, from time to time, such "reasonable periodic, special or

K. EXAMINATIONS

• **Banks are examined to assure the appropriate federal banking regulator that the overall financial condition of the bank is safe and sound. Bank examinations are not focused upon banks' compliance with federal securities laws.**

other examinations" as the Commission deems necessary to enforce the broker-dealer standards of operation and conduct.

Registered broker-dealers are routinely examined by SROs designated by the Commission. When a broker-dealer is a member of more than one SRO, the Commission designates one SRO to examine the broker-dealer for compliance with the financial responsibility rules. (Commission Rule 17d-1)

The Commission conducts broker-dealer oversight and cause exams. Oversight exams enable the Commission to assess how well the SROs' routine examination programs work. Cause exams are performed when special circumstances necessitate the Commission's review of the broker-dealer's financial records and sales practices. Moreover, the Commission staff conducts oversight inspections of all of the SROs' examination, enforcement and regulatory programs to assure that their programs are effective and in compliance with the Exchange Act.

The NYSE and NASD examination programs are illustrative of the use of SROs for examination of registered broker-dealers. These SRO examinations are conducted by a team of examiners specially trained to detect problems peculiar to the securities industry. The examinations focus on, among other things, operational practices and seek to uncover abusive sales practices. NYSE and NASD members must make their books and records available to the Commission, the NYSE and NASD on demand. Violations uncovered by NYSE and NASD examinations can lead to

The federal banking regulators use two tools for the general supervision of all banks: reports and examinations. The primary concern of federal banking regulators is to determine the financial condition of the bank being examined and the bank's compliance with applicable law.

Federal banking law requires annual, full-scope, on-site examinations of all insured depository institutions by the appropriate federal banking regulator. Some exceptions are made for small, well-capitalized and well-managed institutions, and state-chartered institutions need be examined only every other year by a federal agency if a state examination has been conducted for the intervening 12-month period. (12 U.S.C. § 1820)

While banks are subject to examinations by the bank regulators (e.g., 12 C.F.R. § 4.11 (OCC)) those examinations are not primarily focused upon compliance with securities law matters. For example, the OCC's examination guidance with respect to retail nondeposit investment sales is set forth at the end of the "Other Areas of Examination Interest" section, behind section 412, "Discount Brokerage Activity." (See OCC Bulletin 94-13 at 1) The regulators use a uniform institution rating system (CAMEL) to analyze the individual banks being examined. Each of five CAMEL factors is rated on a scale of one to five (with one being the most favorable). The scores of the five factors are combined into a composite rating showing the overall condition of the bank.

The Interagency Statement of the federal banking agencies charges

significant sanctions, including suspension or expulsion from the industry and heavy fines. In addition, the NASD engages in the review of its members' advertising. Broker-dealers' first-time advertisements and collateralized mortgage obligations are reviewed before use. Other advertisements are reviewed subsequently. (NASD Rules, art. III § 35)

banks to develop and implement policies and procedures to ensure that nondeposit investment product sales activities comply with "applicable laws and regulations" and its guidelines. Banks are directed to conduct the compliance function independently of nondeposit investment product sales and management activities.

Section 413 of the Comptroller's Handbook advises national bank examiners that "[e]ach bank's [nondeposit investment product] sales program is different, and one set of rules may not cover all circumstances or provide all customers with the necessary level of protection." Accordingly, the examiners are instructed to consider overall setting and circumstances to determine whether elements combine to mislead or avoid misleading customers. (<u>See</u> OCC Bulletin 94-13 at 5)

1. <u>Surveillance</u>

a. Detailed trading records are required.

Commission Rule 17a-3 requires broker-dealers to maintain a memorandum of each order, or other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. These memoranda of orders, or trade tickets, are required to show the terms and conditions of the order or instructions and any modification or cancellation thereof. SROs, in turn, require members to report this information for each transaction made by it as promptly as possible. Trade information that is disseminated to the public is usually required to be reported within ninety seconds while the information used to settle the respective

1. <u>Surveillance</u>

Banks are required to keep certain records and furnish confirmations to customers in connection with securities transactions effected for customers (<u>See</u> I.H. 1 and 2, above); these records are subject to review by bank examiners.

obligations of the parties is usually required to be reported by the close of business on the day that the trade is made. The SROs compile all of the reported trade information for regulatory purposes. Rule 17a-1 requires SROs to maintain all information collected in the course of their business and the conduct of their self-regulatory activity.

2. SRO Surveillance Systems

Section 6(b)(1) of the Exchange Act requires each Exchange, as a condition of registration, to comply and enforce compliance by its members with the federal securities laws and the rules of the Exchange. The SROs have developed sophisticated electronic systems that detect possible instances of non-compliance. These systems usually analyze the trade information reported by members on a next-day basis although many sROs have developed systems that monitor and detect potentially wrongful conduct on a real-time basis. After detecting potentially wrongful conduct, SROs are required to investigate and, in appropriate cases, discipline members. SROs obtain additional investigative information directly from members. SROs have formed the Intermarket Surveillance Group ("ISG"), composed of senior market surveillance officers from each SRO, to address information sharing needs and investigative techniques required for surveillance of intermarket trading activity. The ISG has developed the electronic bluesheet system to standardize, and make more efficient, the collection of additional customer information for broker-dealers.

3. Commission Oversight

Surveillance of the securities markets is the primary responsibility of the SROs. The Commission oversees SRO compliance with Section 6(b)(1) of the Exchange Act and in cases where the potential wrongdoer is not a member of a SRO, the matter is referred to the Commission.

4. NYSE Rule 80A and Program Trading

NYSE Rule 80A defines the term "program trading." It also establishes limitations on the entry of program trades after the Dow Jones Industrial Average moves 50 points, in either direction, from the previous day's close. The Rule is designed to limit the most de-stabilizing form of index arbitrage during a market swing.

Federal Securities Laws

The Investment Advisers Act of 1940 ("IAA") and the rules thereunder establish a regulatory scheme for registering investment advisers and regulating their activities. In particular, the IAA provides for a regulatory scheme that includes: registration with the Commission; customer disclosures; fiduciary duties, including specialized antifraud rules; and recordkeeping requirements. In addition, the Investment Company Act of 1940 (the "1940 Act") and the rules thereunder, which regulate investment companies, establish a limited regulatory scheme for investment advisers to mutual funds.

The regulatory scheme under the federal securities laws for investment advisers is grounded in principles of protecting advisory clients. The scheme includes the following major components:

II. INVESTMENT ADVISERS

A. REGISTRATION

• **Federal securities law requires investment advisers to register with the Commission.**

Section 203 of the IAA makes it unlawful for any investment adviser (as defined in the IAA), unless registered with the Commission, to make use of the mails or any means or instrumentality of interstate commerce in connection with his

Federal Banking Laws

Federal banking laws and regulations do not establish a uniform regulatory scheme for banks engaged in investment advisory activities. Banks and bank holding companies engage in a variety of investment advisory activities. While banks have traditionally provided investment advice pursuant to their trust powers, they now also provide individualized investment advice as well as generalized recommendations, financial information, and economic analyses. Some, but not all, bank investment advisers are subject to a regulatory scheme that includes: notice to the appropriate regulator of intent to engage in investment advisory activities, customer disclosures, fiduciary standards, and recordkeeping requirements.

The regulatory scheme under federal banking laws for banks engaged in investment advisory activities is grounded in concepts of depositor protection and preservation of the safety and soundness of the banking system. The scheme includes the following major components:

II. BANK INVESTMENT ADVISERS

A. REGISTRATION

• **Under federal banking law, banks do not have to register as investment advisers. However, banks do have to provide general notice to the appropriate federal banking regulator regarding their investment advisory activities.**

National banks engaging in investment advisory activities are required to file an application with the Comptroller of the Currency. (12 C.F.R. § 9.2) In addition to a request to

or its business as an investment adviser.

Registration with the Commission is accomplished by filing a Form ADV and paying a $ 150 registration fee. (IAA Rules 203-1 and 203-3) Investment advisers are required to make certain disclosures in the Form ADV, described below.

exercise fiduciary powers, the application must include: (i) an opinion of bank counsel that the proposed activities are not in contravention of state or local law, (ii) a statement that the capital and surplus of the bank are not less than the capital and surplus required by state law of state banks, trust companies, and other corporations exercising fiduciary powers, and (iii) sufficient biographical information on proposed trust management to enable the Comptroller to assess their qualifications. (12 C.F.R. § 5.26(e))

Insured nonmember banks must provide written notice to the FDIC prior to acquiring or establishing a subsidiary that acts as an investment adviser to any investment company. (Such a subsidiary would be regulated under the IAA.) (12 C.F.R. § 337.4(d)(2)) The FDIC requires state nonmember banks to submit applications for FDIC approval to exercise trust powers. (12 C.F.R. Part 333)

Regulations adopted by the Federal Reserve Board permit bank holding companies and their subsidiaries to act as investment advisers. (12 C.F.R. § 225.25) A notice or application must be submitted prior to engaging de novo in such activities or acquiring a company engaged in such activities. (12 C.F.R. § 225.23) State member banks may not provide fiduciary services to customers without the express permission of the Federal Reserve. (F.R.R.S. 3-428)

B. CUSTOMER DISCLOSURES

- **Investment advisers must disclose certain information to both the Commission and States**

B. CUSTOMER DISCLOSURES

- **Federal banking regulations require banks and bank holding companies acting as investment**

and to their customers, and subsequently are required to take additional steps to keep their registrations in good standing.

Part I of the Form ADV is primarily for the use of the Commission and the States, and requires advisers to disclose such information as: (i) who controls the adviser and how the adviser's operations are financed, (ii) the adviser's trade name, (iii) how the adviser will maintain custody of client assets, (iv) whether the adviser has been subject to disciplinary action by federal and state regulators, and (v) whether the adviser holds itself out as a financial planner and, if it does, the number of those clients and the size of their investments.

Part II of the Form ADV, which, when given to a client, satisfies the IAA's "brochure rule" (Rule 204-3), is primarily for clients' use and requires advisers to disclose such information as: (i) whether the adviser calls any of its services "financial planning," (ii) a discussion of the types of advisory services the adviser provides and the advisory fees it charges, (iii) types of securities about which the adviser provides advice, (iv) the methods of security analysis the adviser uses, (v) the adviser's affiliations with other securities professionals, (vi) whether the adviser effects securities transactions, as broker or as principal, for advisory clients, (vi) whether the adviser has brokerage or investment discretion on behalf of clients, and (vii) a description of the education and business background of the adviser.

advisers to make certain disclosures to bank investment advisory customers.

Banks that exercise investment discretion with respect to a particular account must make certain periodic disclosures to their customers regarding investment activity in those accounts. The bank must mail or otherwise furnish to each customer at least once every three months an itemized statement specifying the funds and securities in the custody or possession of the bank at the end of such period and all debits, credits and transactions in the customer's account during such period. (12 C.F.R. § 12.5(c) (OCC); 12 C.F.R. § 344.1 et seq. (FDIC); 12 C.F.R §208.8(k)(4)(iii) (Federal Reserve Board)

Bank holding companies and subsidiaries and/or affiliates of insured nonmember banks must advise customers in writing that securities recommended, offered or sold by them are not FDIC insured deposits, and are not deposits, obligations of, or endorsed or guaranteed in any way by, any bank, unless that happens to be the case. Bank holding companies and their nonbank subsidiaries also are required to disclose in writing to the customer the role of the company or affiliate as adviser to the investment company. (12 C.F.R. § 225.125(h); 12 C.F.R. § 225.25(b)(15)(ii)(A) (Federal Reserve Board); 12 C.F.R. § 337.4(h)(2) (FDIC))

In addition, the disclosure provisions of the Interagency Statement (See I.J. above) apply. The Interagency Statement also states that a bank should disclose advisory or other

The information required by Part II of Form ADV must be delivered to a client or prospective client at least 48 hours prior to entering into an investment advisory contract, unless the client retains the right to terminate the contract within a certain time. (IAA Rule 204-3(b))

IAA Rule 204-1 requires registered advisers to fulfill certain requirements in order to keep their registrations in good standing, such as amending the Form ADV in a timely manner if circumstances change and filing annual reports on Form ADV-S with the Commission.

In addition, registered advisers have a duty to disclose to their clients precarious financial conditions and prior material legal or disciplinary actions. (IAA Rule 206(4)-4)

Registered advisers may also be required to comply with certain disclosure requirements under the Securities Exchange Act of 1934.

material relationships between the bank or its affiliate and investment companies whose shares are sold by the bank.

C. **FIDUCIARY DUTIES**

● **Registered investment advisers are subject to certain fiduciary standards.**

Registered advisers are subject to a fiduciary duty intended to eliminate or expose conflicts of interest and prevent advisers from overreaching or taking unfair advantage of a client's trust. Court cases (See, e.g., Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)) and Commission releases (See, e.g., In the Matter of Alfred C. Rizzo, Investment Advisers Act Rel. No. 897 (Jan. 1, 1984)) have

C. **FIDUCIARY DUTIES**

● **Under federal banking law, banks acting as investment advisers are subject to certain fiduciary standards.**

Regulations governing national banks require them to adopt certain procedures to administer their fiduciary powers. Among other things, they must: (i) at least once during every calendar year, and within 15 months of the last review, review all the assets held in or for each fiduciary account to determine the advisability of retaining or disposing of the assets; (ii) have their trust department officers and employees bonded;

articulated key elements of a registered investment adviser's fiduciary duty as: (i) best execution, (ii) suitability, and (iii) utmost and exclusive loyalty to the client.

In addition, the fiduciary duty is embodied in IAA provisions and Commission rules. These provisions and rules govern the types of fees that advisers can charge, their ability to engage in principal and agency cross transactions with clients, and advertising and solicitation practices. (See IAA Sections 205(a)(1) and 206(3), Rules 206(4)-1 and 206(4)-3) These and other provisions related to an adviser's fiduciary duty are described more particularly below.

(iii) designate, employ or retain legal counsel to pass upon fiduciary matters; and (iv) adopt written policies and procedures designed to ensure that the federal securities laws are complied with in connection with any decision or recommendation to purchase or sell any security. (12 C.F.R. § 9.7(b)-(d))

The fiduciary activities section of the Comptroller's Handbook for Compliance focuses on compliance in the areas of conflicts of interest and investments.

In addition, OCC regulations prohibit self-dealing in the banks' investment advisory activities with regard to funds and property held in a fiduciary capacity. (12 C.F.R. § 9.12(a)-(c))

Insured nonmember banks which have subsidiaries or affiliates that act as investment adviser to any investment company may not engage in a number of enumerated activities with such subsidiaries or affiliates or with such investment company. (12 C.F.R. § 337.4(e))

Bank holding companies and their bank and nonbank subsidiaries should observe the standards of care and conduct applicable to fiduciaries when providing portfolio investment advice, and, to prevent conflicts of interest, bank holding companies and their bank and nonbank subsidiaries should refrain from engaging in certain enumerated activities with any investment company for which it provides investment advice. (12 C.F.R. § 225.25(b)(4) at n. 1, 12 C.F.R. § 225.125(g)-(h))

1. Compensation

● **The IAA prohibits registered advisers from collecting "performance fees" based on the success of their investment advice, with certain exceptions.**

Section 205(a)(1) of the IAA prohibits a compensation arrangement known as a "performance fee" (compensation based on a percentage of the capital appreciation in a client's account), except for fees that increase and decrease proportionately with the client's investment performance in relation to an appropriate index, and except for fees in certain cases involving persons and entities with significant assets.

2. Agency Cross and Principal Transactions

● **Registered advisers are prohibited from acting as broker or principal in buying or selling securities from a client.**

IAA Section 206(3) makes it unlawful for an adviser, in certain cases, to act as broker for both a client and the person on the other side of the client's transaction, or to act as principal in buying from or selling securities to a client.

1. Compensation

● **Federal banking law generally does not put limits on the kinds of fees bank advisers may charge.**

However, while national banks may charge a fee for management of a collective investment fund, the fractional part of such fee proportionate to the interest of each participant must not, when added to any other compensations charged by a bank to a participant, exceed the total amount of compensations which would have been charged to said participant if no assets of said participant had been invested in participations in the fund. (12 C.F.R. § 9.18(b)(12))

2. Agency Cross and Principal Transactions

● **Federal banking law does not expressly prohibit bank advisers from acting as broker or principal in buying or selling securities from a client. However, general principles of fiduciary law require bank fiduciaries to maintain undivided loyalty to the client and to avoid conflicts of interest. Moreover, banking regulations contain some guidelines regarding transactions to avoid so as to generally prevent conflicts of interest.**

For example, as noted above, insured nonmember banks which have subsidiaries or affiliates that act as investment adviser to any investment company may not engage in certain enumerated activities with such subsidiaries or affiliates or with such investment company. (12 C.F.R. § 337.4(e)) Similarly, to prevent conflicts of interest, bank

holding companies and their bank and nonbank subsidiaries should refrain from engaging in certain enumerated activities with any investment company for which they are providing investment advice. (12 C.F.R. §§ 225.25(b)(15), 225.125(g)-(h)) State member banks must establish written policies and procedures for the crossing of buy and sell orders on a fair and equitable basis. (12 C.F.R. § 208.8(k)(5)(iii))

3. Antifraud Provision

• **The IAA imposes certain antifraud requirements on registered advisers.**

Section 206 of the IAA makes it unlawful for any registered investment adviser using the mails or interstate commerce to defraud, deceive, or manipulate any client or prospective client, and subsection (4) of section 206 gives the Commission authority, by rule or regulation, to define and prescribe those acts or business practices which are fraudulent, deceptive, or manipulative. The Commission has adopted four rules pursuant to this authority:

3. Antifraud Provision

• **The federal banking statutes do not include provisions expressly prohibiting fraud in connection with bank investment advisory activities. However, banks and bank employees who provide investment advice are subject to the antifraud provisions of the Exchange Act (Section 10(b) and Rule 10b-5 thereunder). (See additional discussion of this issue, supra, at I.C.)**

a. Advertising

• **Registered investment advisers are prohibited from engaging in false advertising.**

Rule 206(4)-1 proscribes various advertising practices as fraudulent, deceptive, or manipulative within the meaning of section 206(4).

a. Advertising

• **Federal banking regulations contain only limited restraints on the kinds of advertising permitted for banks engaging in investment advisory activities.**

National banks are prohibited from advertising common trust funds, with limited exceptions. (12 C.F.R. § 9.18(b)(5)(v))

FDIC regulations prohibit any subsidiary or affiliate of an insured nonmember bank that is engaged in securities activities that are not permissible for the

bank itself from (i) sharing the same or a similar name or logo with the bank, (ii) conducting business in the same location as the bank, (iii) advertising or promoting particular securities, and (iv) placing "stuffers" in communications with bank customers unless certain disclosure requirements are met. (12 C.F.R. § 337.4(h)) The disclosures are designed to apprise customers that securities recommended, offered or sold are not insured deposits or obligations of the bank.

b. Custody of Client Assets

● **Registered advisers who have custody of the funds or securities of their clients are subject to heightened requirements with respect to steps they must take to ensure the safety of the funds or securities, and disclosures they must make.**

Rule 206(4)-2 requires that registered advisers who have custody or possession of the funds or securities of their clients take certain steps to ensure the safety of such funds or securities, such as, segregating and marking all securities of each client, maintaining a separate account for each client with records for each such account, and sending quarterly statements to each client.

b. Custody of Assets

● **Bank investment advisers with custody of client funds or securities are not subject to uniform requirements with respect to steps they must take to ensure the safety of the funds or securities, or disclosures they must make.**

It is noted, however, that national banks exercising fiduciary powers are required to keep the assets over which they exercise fiduciary powers separate from the assets of the bank. Each of the fiduciary assets must be placed in the joint custody or control of at least two bank officers or employees designated for that purpose by the bank's board of directors or by one or more officers designated by the board. All such officers and employees must be adequately bonded. The assets of each account must be either: (i) kept separate from those of all other accounts, or (ii) adequately identified as the property of the relevant account. (12 C.F.R. § 9.13; see also "Statement of Principles of Trust Department Management," FDIC Trust Examination Manual; Federal

Reserve Board *Trust Examination Manual*, ch.2)

c. Solicitations

• Registered advisers must comply with certain requirements when paying someone to solicit business.

Rule 206(4)-3 prohibits an adviser from paying a cash fee to one who solicits clients unless certain requirements are met.

c. Solicitations

• Federal banking regulations do not contain provisions for bank advisers that pay someone to solicit business.

d. Financial and Disciplinary Disclosures

• As noted above, registered advisers have a duty to disclose to their clients precarious financial conditions and prior disciplinary actions.

Rule 206(4)-4 imposes a fiduciary duty on registered advisers to disclose to clients precarious financial conditions of the adviser and prior material legal or disciplinary events.

d. Financial and Disciplinary Disclosures

• Under federal banking law, bank advisers do not have a specific duty to disclose to their customers precarious financial conditions or prior material legal or disciplinary actions.

4. Duty to Supervise

• Registered advisers have a duty to supervise.

Section 203(e)(5) of the IAA imposes on registered advisers a duty to supervise and responsibility for persons acting on their behalf.

4. Duty to Supervise

• Federal banking law does not impose on bank advisers an express duty to supervise or responsibility for persons acting on their behalf. (*See* additional discussion of this issue generally, *supra*, under I.E.)

5. Chinese Walls

• Registered advisers are required to maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the advisers or their associated persons.

Section 204A of the IAA requires registered investment advisers to

5. Chinese Walls

• National banks are required to adopt written policies and procedures to prevent the misuse of material inside information by their trust departments.

National banks exercising fiduciary powers are required to adopt written policies and procedures to ensure that their

establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse in violation of the IAA or the Exchange Act of material, nonpublic information by the investment adviser or any associated persons.

trust departments will not use material inside information in connection with any decision or recommendation to purchase or sell any security. (12 C.F.R. § 9.7(d); see also FDIC Trust Examination Manual; Federal Reserve Board Policy Statement Concerning Use of Inside Information (Mar. 17, 1978) and Trust Examination Manual at 15)

D. RECORDKEEPING REQUIREMENTS

• **Registered investment advisers are required to maintain certain kinds of books and records respecting their investment advisory activities.**

Rule 204-2 of the IAA generally requires an adviser to maintain two types of books and records, all of which must be maintained and preserved in an easily accessible place for a period of not less than five years. First, the adviser is required to keep certain accounting records that any business would normally keep, such as: (i) all check books, bank statements and cancelled checks, (ii) all written agreements entered into by the adviser with any client or otherwise relating to the business of the adviser, (iii) all bills or statements relating to the adviser's business, and (iv) all trial balances, financial statements and internal audit working papers relating to the adviser's business.

Second, registered advisers are required to keep certain records the Commission believes are necessary in light of the adviser's fiduciary duty, such as: (i) a record of the personal securities transactions of the adviser and its employees, (ii) a memorandum of each order given by the adviser for the purchase or

D. RECORDKEEPING REQUIREMENTS

• **Federal banking law does not generally require bank investment advisers to keep particular records respecting their investment advisory activities.**

It is noted, however, that national banks exercising fiduciary powers are required to keep their fiduciary records separate and distinct from other records of the bank. All fiduciary records shall be kept and retained for such time as to enable the bank to furnish such information or reports with the Comptroller. The fiduciary records must contain full information relative to each account. Also, national banks exercising fiduciary powers are required to keep an adequate record of all pending litigation to which it is a party in connection with its exercise of fiduciary powers. For purposes of examination by the Comptroller, a national bank shall retain the records required for a period of three years from the later of the termination of the fiduciary account relationship to which the records relate or of litigation relating to such account, unless applicable law specifically prescribes a different period. (12 C.F.R. § 9.8)

sale of any security and any instruction from the client concerning such purchase or sale, (iii) the originals of all written communications received and copies of all written communications sent by the adviser relating to recommendations made or advice given, any receipt, disbursement or delivery of funds or securities, or the placing or executing of any order to purchase or sell any security, (iv) copies of all circulars, advertisements, newspaper articles, etc., sent to ten or more persons, (v) a list of all accounts that the investment adviser has discretionary authority over, (vi) a copy of each written statement given to any client in compliance with the brochure rule, (vii) copies of clients' acknowledgement of receipt of the disclosure required by Rule 206(4)-3, regarding the adviser's payment of fees for solicitation of clients, and (viii) all records necessary to form the basis for performance information in advertisements.

In addition, registered advisers who have custody or possession of securities or funds of any client must keep additional records regarding that activity (Rule 204-2(b)).

[In addition, as noted above, banks that effect transactions in securities for customers in conjunction with investment advisory services are subject to recordkeeping requirements. (12 C.F.R. §§ 12.6, 208.8(k), 344.6(d)]

E. EXAMINATIONS

● **Registered investment advisers are subject to both routine and cause inspections of their investment advisory activities.**

The Commission's examinations focus on ensuring compliance with the various IAA requirements as to recordkeeping, reporting, advertising, conflicts of interest, and other matters, and

E. EXAMINATIONS

● **Although bank fiduciary activities are subject to examinations by the federal bank regulators, bank investment advisory activities with respect to advising a registered investment company are not subject to the same kinds of examinations that registered investment advisers are subject to. For example, a bank adviser**

to determine if advisers are acting in accordance with the disclosures and representations made to clients. An adviser may receive a "deficiency letter" or an enforcement proceeding may be commenced as a result of deficiencies found during an inspection.

to a mutual fund is not subject to an examination that focuses on the evaluation of potential conflicts of interest between the adviser and the investment company. Bank examinations' primary focus is on whether the overall financial condition of the bank is safe and sound. (For additional discussion of bank examination procedures generally, <u>see</u> prior discussion, <u>supra</u>, at I.K.)

A national bank's trust department must be audited at least once during each calendar year, and within 15 months of the last such audit, by a committee of directors, or by auditors responsible only to the board of directors. The audit must ascertain whether the department has been administered in accordance with law, the OCC's regulations pertaining to fiduciary powers of national banks, and sound fiduciary principles. A report of the audit must be noted in the minutes of the board of directors. (12 C.F.R. § 9.9; <u>see also</u> FDIC <u>Trust Examination Manual</u>)

As part of each examination, the Comptroller must examine the investments held by such bank as fiduciary, including collective investments, in order to determine whether such investments are in accordance with law, this regulation, and sound fiduciary principles. (12 C.F.R. § 9.11)

F. ENFORCEMENT ACTIONS

• The Commission may bring a civil injunctive action against any person for violations of the IAA or any regulation thereunder. The Commission may bring an administrative proceeding against

F. ENFORCEMENT ACTIONS

• The federal banking regulators may bring administrative proceedings against banks and bank-related parties for engaging in unsafe and unsound practices or violations of laws,

any investment adviser and its associated persons for violations of the federal securities laws and regulations thereunder, and for committing certain acts enumerated in the IAA. The Commission may seek money penalties in both the civil and administrative context, and may impose both temporary and permanent cease-and-desist administrative orders.

1. Civil Actions

Section 209(d) of the IAA authorizes the Commission to bring civil injunctive actions against persons who have engaged, are engaging, or are about to engage in a violation of any of the provisions of the IAA or the rules thereunder. The Commission is also empowered under Section 209(d) to bring an action against persons who have aided or abetted the violation of any provision of the IAA. Section 209(e) authorizes the Commission to seek money penalties in such actions.

2. Administrative Proceedings

In administrative proceedings, Sections 203(e) and (f) of the IAA authorize the Commission to: (i) censure, (ii) place limitations on the activities, functions, or operations of, or (iii) suspend for a period not exceeding twelve months, any investment adviser or person associated with or seeking to become associated with an investment adviser if it finds, on the record after notice and opportunity for hearing, that one of the above sanctions is in the public interest and that such adviser or person associated with or seeking to become associated with an investment adviser has committed (or, in some cases, omitted) one of a number of acts

regulations or supervisory agreements. The banking regulators may seek civil money penalties, and may impose both temporary and permanent cease-and-desist orders.

The federal banking regulators have authority under 12 U.S.C. § 1818 to bring administrative proceedings against banks and bank-related parties for unsafe and unsound practices that pose a financial threat to a bank, or for violations of laws, regulations, or supervisory agreements. (For additional discussion of banks' enforcement authority, see discussion, supra, at I.F.) Banks are also subject to Commission enforcement actions for aiding or abetting violations of the IAA, and for violations of certain provisions of the 1940 Act (with respect to banks and bank affiliates serving as investment advisers to registered investment companies).

enumerated in Section 203(e) of the IAA.

These acts include: (i) willfully violating or willfully aiding or abetting a violation of a federal securities law or rule, (ii) willfully making or causing to be made in any filing required under the IAA a materially false or misleading statement, or making a materially false or misleading omission in such a filing, (iii) being convicted within the last ten years of a securities-related felony or misdemeanor, or (iv) being the subject of a permanent or temporary injunction regarding acting as an investment adviser or other securities broker or dealer, or as an affiliated person of any investment bank, bank, insurance company or equivalent foreign entity.

The Commission may also, in the case of a registered investment adviser, revoke the registration of such adviser, and, in the case of a person associated with or seeking to become associated with an investment adviser, bar such person from becoming associated with an adviser, pursuant to the same procedures and under the same circumstances.

a. Imposition of Civil Money Penalties

In any administrative proceeding commenced pursuant to Section 203(e) or (f) (discussed above), Section 203(i) of the IAA authorizes the Commission to impose civil money penalties against any person, if it finds, on the record after notice and opportunity for hearing, that such penalty is in the public interest, and that such person has: (i) willfully violated any provision of the federal securities laws or regulations

thereunder, (ii) willfully aided or abetted such a violation by another person, (iii) willfully made or caused to be made in any filing required to be made under the IAA, false or misleading statements with respect to any material fact, or has omitted any material fact, or (iv) failed reasonably to supervise, with a view to preventing violations of the provisions of the IAA, another person who commits such a violation, if such person is subject to his supervision.

b. Cease-and-Desist Orders

Section 203(k) of the IAA authorizes the Commission to impose both permanent and temporary cease-and-desist orders if, after notice and opportunity for hearing (unless, in the case of a temporary cease-and-desist order, the Commission determines that notice and hearing would be impracticable or contrary to public interest), the Commission finds that any person is violating, has violated, or is about to violate any provision of the IAA or any rule or regulation thereunder.

SPECIAL REQUIREMENTS FOR INVESTMENT ADVISERS TO REGISTERED INVESTMENT COMPANIES

- **The 1940 Act contains certain requirements applicable to investment advisers to investment companies, including mutual funds, as described below. These requirements are in addition to the regulations applicable to registered investment advisers under the IAA.**

SPECIAL REQUIREMENTS FOR INVESTMENT ADVISERS TO REGISTERED INVESTMENT COMPANIES

- **While banks and bank holding companies are specifically excluded from the IAA's definition of investment adviser, banks and bank holding companies are not excluded from the 1940 Act's definition of investment adviser, and are therefore subject to requirements applicable to investment advisers to mutual funds under the 1940 Act. The 1940 Act's definition of affiliated person includes any investment adviser to a mutual fund, so banks are also subject**

to the 1940 Act's provisions for affiliated persons. Banks are therefore subject to the provisions of the 1940 Act (described at left) in the investment advisers column of this chart. Comparable banking regulations, if any, are discussed, <u>supra</u>, in the sections noted below.

G. INVESTMENT ADVISORY CONTRACT

- **Investment advisers to investment companies are required to have a contract with the investment company, which must contain certain terms, including the amount of compensation.**

Section 15(a) of the 1940 Act requires an investment adviser to a registered investment company to have a written contract. The contract must be approved by a vote of a majority of the fund's outstanding voting securities. The contract must precisely describe all compensation to be paid thereunder. If the contract continues in effect for more than two years, its continuance must be specifically approved at least annually by the fund's board of directors or shareholders. The contract must provide that it may be terminated by the fund's board of directors or shareholders at any time, and without the payment of any penalty, on not more than sixty days' written notice to the adviser. Finally, the contract must provide for its automatic termination in the event of its assignment.

G. INVESTMENT ADVISORY CONTRACT

- **Federal banking law does not require a bank acting as investment adviser to a mutual fund to have an investment advisory contract with the fund.**

H. FIDUCIARY DUTIES

• The 1940 Act imposes fiduciary duties on investment advisers to mutual funds.

Section 36(a) of the 1940 Act authorizes the Commission to bring an action against a fund's investment adviser for any act or practice that is a breach of fiduciary duty involving personal misconduct in respect of the fund. Section 36(b) imposes a fiduciary duty on an investment adviser to a registered investment company with respect to any compensation for its services, or payments of a material nature, paid by the fund or its shareholders.

Section 17 of the 1940 Act contains certain enumerated restrictions on principal and agency transactions between registered investment companies and their affiliated persons. These restrictions are intended to prevent conflicts of interest. As noted above, Section 2(a)(3) of the 1940 Act defines "affiliated person" to include any investment adviser of an investment company.

Section 17(j) of the 1940 Act prohibits affiliated persons of a registered investment company from engaging in fraudulent acts and practices in connection with personal transactions in securities that are held or to be acquired by the fund. To prevent such fraud, Rule 17j-1 under the 1940 Act requires every registered investment company to adopt a code of ethics containing provisions reasonably designed to prevent such fraudulent activities. Further, certain insiders of the investment company and its investment adviser must submit to the fund

H. FIDUCIARY DUTIES

• As noted above, under federal banking law, banks acting as investment advisers to investment companies are subject to certain fiduciary standards. (<u>See</u> additional discussion, <u>supra</u>, at II.C.)

periodic reports on their personal securities transactions.

Section 17(b) of the 1940 Act permits a registered investment company to maintain custody of its assets with any bank. If a fund's custodian bank is an affiliated person of the fund, however, the Commission's staff requires that the custody arrangement comply with Rule 17f-2 under the 1940 Act, which sets forth the conditions that an investment company must meet if it has custody of its own assets. Among other things, the rule requires that an independent public accountant perform at least three audits per year of the fund's assets held by the custodian, at least two of which must be surprise audits.

I. RECORDKEEPING REQUIREMENTS

- **Investment advisers to registered investment companies are required to maintain certain books and records.**

Investment advisers to registered investment companies are subject to the recordkeeping requirements applicable to registered investment advisers under Rule 204-2 of the IAA. (1940 Act Rule 31a-1(f))

I. RECORDKEEPING REQUIREMENTS

- **As noted above, bank investment advisers are generally not required by federal banking law to keep particular records respecting their investment advisory activities. (<u>See</u> additional discussion, <u>supra</u>, at II.D.)**

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